S. HRG. 103–359

# EMPLOYEE STOCK OPTIONS

Y 4. B 22/3: S. HRG. 103-359

Employee Stock Options, S.Hrg. 103-...

## [HE]ARING

[BE]FORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

THE PROPOSAL BY THE FINANCIAL ACCOUNTING STANDARDS BOARD [FASB] EXPOSURE DRAFT, "ACCOUNTING FOR STOCK-BASED COMPENSATION," TO REQUIRE COMPANIES TO RECORD A CHARGE TO THEIR EARNINGS UPON THE GRANT OF AN EMPLOYEE STOCK OPTION

OCTOBER 21, 1993

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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# EMPLOYEE STOCK OPTIONS

**THURSDAY, OCTOBER 21, 1993**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
*Washington, DC.*

The committee met at 10:10 a.m., in room 538 of the Dirksen Senate Office Building, Senator Barbara Boxer presiding.

## OPENING STATEMENT OF SENATOR BARBARA BOXER

Senator BOXER [Presiding]. The subcommittee will come to order. I want to welcome our esteemed guest. I want to also apologize that we are 10 minutes behind schedule. Senator Dodd got called away to run an amendment on the Floor on the Haiti issue, and we apologize. I had to reshuffle my schedule in order to do this.

I would like to begin by reading a statement on his behalf, and then I will ask my colleagues to comment. Then when they are done, I will read my own statement.

Senator Dodd is very disappointed that he cannot be here to open the hearing this morning, and he wanted me to apologize to all of the witnesses. The Majority Leader asked Senator Dodd to act as Floor Manager of the Haiti amendments on the Floor this morning. Debate started at 9:30 a.m. and is expected to go until 11 a.m., at which time there will be several votes stacked back to back. We will have to break at that point for votes, and Senator Dodd will join us right after that.

I know how much he wanted to be here for the entire hearing. He has an opening statement which he asked me to include in the record at the appropriate point, which would be this point, if there is no objection.

I would ask Senator D'Amato for his statement.

## OPENING COMMENTS BY SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you, Madam Chairwoman.

I am going to ask that my statement be placed in the record as if read in its entirety, to save time, so that we can hear from our distinguished colleagues, our first panel.

I would say this, though. I would hope that before we rush into this area, maybe we would deal with some problems that exist as it relates to stock options, the FASB and others, but that we just take a step back and let us not destroy capital formation. Let us not unduly inhibit corporations from the things that we want them to do.

I am very much concerned with what the impact of this rule would be. I think it would be very deleterious, so I would hope that we would all take a step back and analyze this very carefully before we throw the baby out with the bath water.

Having said that, I ask that my full statement be placed in the record as if read in its entirety.

Senator BOXER. Senator Faircloth.

## OPENING COMMENTS BY SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Madam Chairwoman.

In my opinion, the two central threats the American economy and the American businessman faces today is the runaway spending of the Government, totally out of control, and the propensity of the Government to come up with new Federal rules and regulations that they put on the people that try to work and save: taxations and regulations.

The last thing we need in this country is one more rule, one more regulation, or one more new tax.

Today we are talking about a proposal which would have the effect of discouraging our best and brightest from taking a chance in the private sector as entrepreneurs what would be more enticing to stay in the troth and draw the thick salary.

However well intended, this proposed change in the accounting treatment for employee stock options will be one more burden on the private sector of the economy that we least need. What we need now is to get the economy moving and the country moving.

The Federal Government and the Congress, as far as I can remember—and I am getting pretty old—has not convened and adjourned one time in the last 35 years that they did not go home with a new rule, a new regulation, or something to make it more difficult for the private sector to function.

Congress simply does not believe, and has not believed, that there is any limit to the amount of burdens, rules, regulations, restrictions, and taxes that the private sector can carry and will carry without revolt.

It is my hope that we will put this proposed change to bed and never let it see the light of day.

Thank you.

Senator BOXER. Senator Mack, is it all right with you if Senator Bradley presents his testimony?

Senator MACK. I have no opening statement. I would love to hear from Senator Bradley.

Senator BOXER. Is that all right with you, Senator Gramm?

Senator GRAMM. I understand Senator Bradley has got something to do. I assume it is productive work. Let's allow him get on with it.

[Laughter.]

Senator BOXER. As I understand it, he has a markup. Is that correct, Senator Bradley?

Senator BRADLEY. Madam Chairwoman, I thank you. We are in the middle of the NAFTA markup on the Finance Committee——

Senator GRAMM. Yes. Let him go, by all means.

[Laughter.]

He is on God's side on this issue. Keep these other two guys here until I speak.

[Laughter.]

Senator BOXER. Senator Bradley, with that rousing welcome, let me add my voice and welcome you again. Please go ahead.

## STATEMENT OF BILL BRADLEY, U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator BRADLEY. Madam Chairwoman, I also want the record to reflect that if the right side of my face is smiling in a different way than the left side, it is only because I have just come from the dentist.

[Laughter.]

Senator BOXER. Oh, my.

Senator BRADLEY. So I want to thank you and commend you for calling the hearing today.

The debate over the Financial Accounting Standards Board proposal on employee stock options is one that has far-reaching consequences outside of ivory tower discussions about whether stock options are "compensation."

The FASB proposal will seriously jeopardize one of the best tools that American corporations have to attract, retain, and motivate their workers.

It will impose a heavy burden on our crucial high technology and entrepreneurial sectors, and it will do so for little gain or at a cost to our system of financial reporting.

Madam Chairwoman, I am reluctant to have Congress weigh in on issues of accounting standards, but Congress cannot remain silent when in the pursuit of questionable accounting purity FASB threatens entrepreneurship and growth.

For that reason, I have joined my good friend, the distinguished Congresswoman from California Anna Eshoo in offering a Sense of the Congress Resolution that asks FASB to reverse its position on stock options. Until FASB makes its final decision, that is as far as I feel Congress should go on this issue.

Let me state at the outset that I do not believe that the debate we are having today is about whether CEO's in America are being paid too much.

If we want to control executive compensation, we should focus on strengthening shareholders' hands against entrenched management.

We should tighten disclosure and improve our proxy and independent director approval processes. I commend the recent SEC requirements to this end.

The recent budget bill also included a cap on corporate tax deductions for executive compensation. That proposal imposes new requirements on executive stock options. These measures should be given a chance to work, although I doubt that they will—but only time will tell.

Ironically, I think that the FASB proposal will have the opposite effect of the one intended by its proponents. The CEO's will continue to get their pay packages. It is the rank and file employees that will be harmed. The companies that will be penalized the most

through this proposal are the ones that offer stock option plans to all employees, not just to senior management.

This proposal puts the company in a position of abandoning its broad-based stock option plan or taking a large hit on earnings.

Madam Chairwoman, the real debate we are having today is whether the benefits of the FASB proposal outweigh its costs. In its mission statement, FASB states that it should "promulgate standards only when the expected benefits exceed the perceived costs." I feel that the proposal we are looking at today fails this standard.

The burden of the FASB proposal will fall disproportionately on our Nation's high technology sector. These companies will be hit twice. Not only do they rely much more heavily on stock options than other companies, but they also show more stock price volatility.

Under the FASB proposal, this volatility will require them to take even larger earnings charges. One survey by the Wyatt Company indicated that high technology companies will suffer an almost 50 percent decline in earnings, while other companies will have a loss of about 6 percent of their earnings.

Given that this sector—the high technology sector—will play an increasingly important role in the American economy, I question the wisdom of putting them at a disadvantage in capital markets, which is what I think this proposal does.

Worse, the biggest hit will be taken by entrepreneurial companies. Start-ups must often rely on granting options to attract employees. They make up for the riskiness of their ventures by sharing the up-side potential with their employees. Now remember, I am saying "employees" here, not senior management.

Unlike other forms of compensation, stock options also result in a net inflow of capital into the corporation. While their costs fall largely on corporate shareholders, they are already subject to shareholder approval, and their dilutionary impact is disclosed by earnings per share calculations.

FASB's proposal will make these stock options much more expensive to provide, needlessly putting in jeopardy the successful model of entrepreneurship in this Nation. We might be able to justify these costs, significant as they are, if there were offsetting benefits in the form of more credible financial statements, but the expense that FASB will be requiring will be uncertain and speculative.

FASB's proposal requires an immediate charge against earnings regardless of whether the stock price rises or whether the options are actually exercised.

FASB is also relying on models designed for publicly traded options to assign values to these options which are not publicly traded. This is a faulty analogy.

Employee stock options are nontransferable and subject to stringent vesting requirements.

Further, FASB's proposal eliminates stock price volatility as a variable for privately held companies. If the end goal for FASB is comparability and credibility, then one has to question whether that end is served by different models applying to different companies.

It is for this reason that major shareholder groups, the true customers of the financial statements, have come out against the FASB proposal.

Quoting from the United Shareholders Association:

> We do not believe FASB's proposal would clarify the reports we receive. In fact, we believe that including speculative estimates of future stock options values in corporate earnings statements diminishes rather than enhances their usefulness.

In any cost-benefit analysis, it is critical to consider possible alternatives. So if you oppose the FASB standard, what do you propose?

In this instance, a reasonable compromise would be an expanded footnote disclosure. If the goal is to provide shareholders with information about the cost of stock options and a basis on which to make company-to-company comparisons, then an appropriate response would be to require an unambiguous, uniform disclosure.

Not surprisingly, this is the approach that has been favored by the major business associations, the Big Six accounting firms, and the major shareholder associations. When management, their accountants, and their shareholders can all agree on something, then it is time for Congress to pay attention.

Madam Chairwoman, I want to thank you for the opportunity to testify today. It is not too late for Congress to send a clear signal to FASB that questionable accounting purity cannot be allowed to jeopardize entrepreneurship and economic growth.

I hope to work with you and other Members of the committee on this issue. I am particularly pleased to be joined at the table today by my good friend from California who is the true leader on this issue. She is the one who has pioneered the movement to challenge this standard. I salute her for it. Her understanding of the potential impact of this proposal in my view is unparalleled, and I am sure that you will all benefit from hearing her remarks today.

I thank you so much for the opportunity to come before the committee.

Senator BOXER. Thank you very much, Senator Bradley.

Senator Mack, are you sure you do not want to put a statement in?

## OPENING COMMENT BY SENATOR CONNIE MACK

Senator MACK. Yes, thank you.

Senator BOXER. Senator Shelby.

## OPENING COMMENT BY SENATOR RICHARD C. SHELBY

Senator SHELBY. Madam Chairwoman, I have a statement that I would like to be made a part of the record. I want to commend you and Senator Dodd for holding these hearings.

I want to hear from the witnesses, including my colleagues and Congresswoman, but this is a very dangerous situation. To me, this seems like FASB is turning anti-business in the world.

Senator BOXER. Without objection, we will place this in the record.

Senator Gramm.

## OPENING STATEMENT BY SENATOR PHIL GRAMM

Senator GRAMM. First of all, I intend to vote for the Sense of the Congress Resolution. If that is unsuccessful, I intend to work to try to overturn this proposal legislatively.

I am concerned at the prospect of Congress getting into accounting standards, because normally when we have done it in the past it has been harmful to the country, to the accounting profession, and to economic growth.

But the bottom line here is, this is a stupid proposal.

[Laughter.]

When you are talking about stock options, to argue that their issuance is somehow lowering the earnings of the company simply makes no sense.

It does dilute the wealth of shareholders. It does dilute their earnings. But to argue that you have to deduct the options from earnings is phony. Take, for example, a company that is making money. It uses stock options as incentives. The company is earning profits and piling them up in a bank account, but on the books it could be declaring losses yet and the company actually has the resources to turn right around and pay dividends. This is just a silly proposal.

I think, quite frankly, that we ought not to allow it to happen. I am delighted that we have so much leadership from our colleagues here who are concerned about this.

I cannot imagine that there is going to be much support in Congress for this proposal. I hope the decision will be made to change the standard and we will not have to legislate. I think it is very dangerous to get Congress into this business, but in this case, I think we would have to do it. I would support it reluctantly, if that was what was required.

Senator BOXER. Thank you very much, Senator Gramm.

I would like to ask unanimous consent to place my entire statement into the record.

I would like to say that I am very heartened by the bipartisan support there seems to be out there, although I know that we will hear a different view in a moment. But it seems to me that when you get Senator Bradley and Senator Gramm and Senator Mack and Senator Boxer and Senator Shelby and Senator Faircloth on the same team, along with Congresswoman Eshoo and Senator Lieberman, we are off to a good start.

[Laughter.]

Senator GRAMM. And it must be a pretty popular position.

[Laughter.]

Senator BOXER. Well, not only is it popular, it is right. It simply is not acceptable to pursue an abstract accounting theory at the expense of California business. The FASB proposal would damage California business and this would be a disaster.

I just wanted to alert my colleagues to the next panel, because I am so pleased that Lisa Conte, president and CEO of Shaman Pharmaceuticals is here to testify. Shaman Pharmaceuticals is a northern California company working to develop new classes of pharmaceuticals derived from rain forest plants.

Lisa runs one of California's bright-spot companies. This company went from one to 90 employees in just 4 years, after an initial

public offering raised a substantial amount of capital. She provides all of her employees with stock options, and is here to tell us that the FASB proposal is misdirected, unnecessary, and harmful to the long-term growth potential of her industry, which is an industry that is one of the great hopes for job creation and economic recovery in California.

So I hope that you can meet Lisa. She is an extraordinary person. Again, we tend to talk in abstractions and here is someone who can talk about the reality of what it is like out there.

At this point I see Senator Murray has joined us. Do you have an opening statement, Senator Murray?

### OPENING COMMENT BY SENATOR PATTY MURRAY

Senator MURRAY. Thank you, no. I am just delighted to be here on this topic today. It is an extremely important one to many industries in the State of Washington, the new and emerging biotechnology technology companies and ones that are going to be our super future employers. So we are very interested in this topic.

Senator BOXER. Thank you, Senator Murray.

At this point I am going to now ask Congresswoman Eshoo, talking about bright spots, a bright spot in the House of Representatives, someone who represents Silicon Valley, someone who raised this issue with me, frankly, or as soon as this proposal surfaced.

Representative Eshoo, we welcome you here.

### STATEMENT OF ANNA G. ESHOO, U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Representative ESHOO. Thank you, Madam Chairwoman. It is an honor to be here and to see you chairing this important committee, and to the distinguished Members of the committee, thank you for allowing me to provide testimony this morning on this critical issue.

I would like to ask that my written statement be made part of the record, as well.

Senator BOXER. Without objection, so ordered.

Representative ESHOO. I would like to associate myself with the remarks of my friend and colleague, Senator Bradley. I am going to try to be brief where he went into detail, but I would also like to thank him for becoming the chief Senate sponsor of the Resolution that I have offered in the House.

This is certainly a complex issue. The range of Congressional response to the Financial Accounting Standards Board's recent proposal really does nothing to simplify it. Supporters of the FASB proposal argue that it will put an end to highly publicized fat-cat executive salaries. This is certainly a worthy goal, and I want to stress that I strongly support improved financial reporting and disclosure of employee compensation.

However, this proposal will primarily affect thousands of average working Americans, not easy to target top executives. Furthermore, by discouraging the use of stock options, this proposal will adversely affect the ability of entrepreneurs and start-up companies from prospering or even getting off the ground.

FASB's proposal will have the most devastating impact on the country's most competitive industry, high technology. I represent

Silicon Valley where some of this country's largest and most competitive companies such as Hewlett-Packard, Apple, Sun Microsystems, and Advanced Micro Devices literally grew out of a dream.

Many of the innovators in my district started with an idea and maybe a garage to work out of. But without stock options, the ability to give their employees a piece of the dream, most would not have survived. They said to their employees, we know that there is a risk. We don't have a great deal to pay you, but we would like to offer you something of a reward for the risk that you will take. And the rest is history—sweet history, I might add.

For these and other high-tech companies, the FASB proposal simply does not compute. The astounding vitality of the high-tech industry is attributable in part to the continued use of stock options which encourage employees ongoing commitment to a company's success. Given this, I really don't understand how today in the face of increasing competition overseas we can even consider devaluing this important tool.

Yet, by requiring companies to charge against their earnings the value of stock options, the benefits of using stock options are effectively negated. Indeed, a recent survey—and Senator Bradley underscored this—indicated that high-tech companies would suffer close to a 50 percent reduction in profits if they would continue to use stock options under the new accounting rule. No incentive is worth that much to any company, particularly start-up firms which need investment capital.

Although I feel very strongly about this issue, I feel just as strongly that Congress should not interfere with FASB's lengthy standards-setting process.

If any one of us were to hear that their State legislators had legislation that was going to regulate the State bar association, we would laugh. So I don't really believe that we should get into this, nor should FASB. By introducing our non-binding Resolution, Senator Bradley and I join with Treasury Secretary Bentsen, members of the SEC, and over 40 of our colleagues in stating our concern about the economic implications of the FASB proposal.

We are charged with economic outcomes in the Congress. Legislating stock option accounting at this point, whether for or against the FASB proposal, I believe would be inappropriate.

I only hope that FASB listens carefully to all of our concerns as it considers its proposal. This is the six-month public hearing process, and so it is appropriate for the Congress I believe to weigh in.

In closing, I would like to reiterate that I understand and agree with concerns about executive compensation. These concerns can best be addressed through greater financial disclosure and reporting such as the recent SEC rule which increases disclosure obligations of public companies.

I also appreciate FASB's desire to treat stock options like other forms of compensation, but stock options are not like other forms of compensation and should not be treated as such. To do so would result in adverse and far-reaching economic consequences as this Nation seeks to grow out of the economic mess that it finds itself in.

Madam Chairwoman, once again I would like to thank you for holding this hearing today. I look forward to working with you and all the Members of this committee, and the Members of the Senate on this critical issue.

Thank you, very much.

Senator BOXER. Thank you very much, Congresswoman. Can you stay with us until we finish the panel?

Representative ESHOO. I cannot. I need to get back over to the House for a hearing, and I apologize for that. But I look forward to working with the Members in answering any questions that you might have. I certainly look forward to that. We can do that one on one, or I can come back at any time.

I thank you for this opportunity.

Senator BOXER. Thank you, very much.

Representative ESHOO. I would like to put in a plug for those who have not signed onto anything yet, that you join with Senator Bradley and myself.

Thank you very much.

Senator BOXER. Thank you very much, Congresswoman.

Senator GRAMM. What kind of stock options are you using as an incentive?

[Laughter.]

Representative ESHOO. Pardon me, sir?

Senator GRAMM. What kind of stock options do you get if you sign on?

[Laughter.]

Representative ESHOO. The betterment of our economy.

Senator BOXER. No, but your stock would go way up with Congresswoman Eshoo if you signed up.

[Laughter.]

Representative ESHOO. Thank you, Madam Chairwoman.

Senator LEVIN. I think that is a stock answer, though.

[Laughter.]

Senator BOXER. Wait a minute. [Hits gavel.]

Senator Lieberman, we are very happy you are here. You have taken the lead in going to the next step, which is the step that Senator Gramm outlined if we are not successful through the public hearing process in changing FASB's mind. I think your legislation, which I am proud to be a co-sponsor of, as is Senator Mack and others, is the obvious next step and we look forward to your testimony.

## STATEMENT OF JOSEPH I. LIEBERMAN, U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator LIEBERMAN. Thank you very much, Madam Chairwoman. It is a pleasure to be here. I thank you and Senator Dodd for convening the hearing, and Members of the committee.

I approached this from a broader economic context. As you know too well, each of us from other ends of the country, that this has been a tough 5 or 6 years in our economic history. We have taken a real beating.

Connecticut itself has lost close to 200,000 jobs. But unlike the job losses we suffered in past recessions, a lot of these jobs are not

coming back. These are jobs that are the result of downsizing and restructuring and some companies going out of business.

It is clear to me, as I know it is to you, that if we are going to re-employ a lot of those people who are very able and want to work, they are going to have to be re-employed as the result of entrepreneurs and risk-takers starting new businesses and creating new jobs.

That is the perspective that brings me to the issue of stock options, because I think stock options are such a powerful incentive for new businesses, and a tremendous benefit for a great mass of American workers. That is why I have introduced the legislation that I am privileged to have you and Senator Mack and others as co-sponsors of.

Let me just state that there are two parts to my legislation. One is a specific response to the FASB ruling and a direction to the SEC to maintain current accounting treatment of stock options.

The other part of the legislation would go on even if the FASB rule is for some reason changed or overruled. That is, to create a new class of stock options called "performance stock options" which make the stock option mechanism more attractive, give some encouragement for those who have them to hold them a longer period of time and enjoy an exclusion on the tax that they ultimately take, and create incentives for what is actually already happening, but if it is not in a company this will provide a tax incentive, and that is to share the benefit of these stock options well beyond the highest level of management within the company.

I did not arrive at the position to introduce legislation to overrule FASB easily or quickly because, as others have stated, generally speaking I think accounting practices ought to be left to the private sector. But my own conclusion is that the FASB stock option proposal is so damaging to job creation and economic growth, perhaps inadvertently so as the folks at FASB say, but nonetheless we would be abdicating our responsibilities in Congress if we did not weigh in the process and try to prevent the damage from occurring.

Stated briefly, the FASB ruling in requiring companies to take a charge for stock options against earnings will dramatically reduce the earnings per share ratio of companies, thereby making it harder for them to raise capital and to grow, and it will also reduce their incentives for using stock options more broadly among their employees and thereby deprive a lot of hardworking Americans from getting this benefit.

You are going to hear a lot, have already heard a lot, and will hear more from people who will speak to you today. I want to give you three brief points.

First, stock option plans are broad-based and growing. As others have indicated, the FASB ruling has become mixed in with the whole question of the fairness or the extravagance of chief executive officer compensation in this country.

Now the stories that may be told today, and have been heard and told before, obviously are true. The public outrage at some of these rates of compensation is understandable, but the basic point I think that we have to make is that these stories are clearly the exception and not the rule—that is, in the use of stock options.

If there is a governmental response necessary to those levels of chief executive compensation, it ought not to come as a result of the destruction of the stock option method. This is a classic case of throwing out a net that is vastly wider than the targets of public anger and catching in that net a lot of innocent, hardworking people who deserve these stock options.

The fact is that the overwhelming number of people who benefit from stock option plans are middle-income Americans, not upper-income Americans. These plans are used by a lot of companies whose names are familiar to us, such as Microsoft and Genetech and the like, but they are used by a lot of non-hightech companies like Wal Mart and one of my favorites here is Wendy's, which gives its stock options not just to Dave Thomas who we all see on the TV, but right down to the counter people at Wendy's, and that is a tremendous motivation for them.

You are going to hear a lot of data presented this morning to substantiate the broad base of stock option recipients. Let me just mention one survey which was completed just a couple of days ago that shows that, of companies with fewer than 100 employees that offer stock options, 90 percent of them offer options to every single employee, not must most employees, but to every single employee of that company.

The second point: Stock options really do represent opportunity for the businesses and the employees alike making it possible to start new companies and to create new jobs, making it possible, as I have heard over and over again from CEO's of companies, to attract key people from larger companies where they are making more money, but they are willing to come and take a smaller salary knowing that they're going to get a piece of this new company and an opportunity to improve their own personal positions.

Stock options are used in tens of thousands of companies and really benefit millions of mid-level, middle-income workers. For these people, it is an opportunity not just to work for the company, but to become part owner of the company.

In a much more personal sense, these stock options for these hundreds of thousands of middle-income Americans represent the extra bonus, that dividend which will allow them to put a down payment on a house, send a child to college, or begin to put together a retirement nest egg.

The final point is cost versus benefits. The fact of the matter is, when we come specifically to the FASB ruling, that the accounting change—again perhaps inadvertently—nonetheless will quite tangibly cost jobs and impair competitiveness. The witnesses that you are going to hear this morning will make that clear. But what are the benefits that we get for that cost?

Well, supposedly we are going to get better and clearer financial statements. As Senator Bradley indicated, there are other ways with Footnotes to do that.

It is not clear that this change will in fact give better and clearer financial statements even on that level of accounting practice. The fact is that the proposal is opposed by virtually every business group, by virtually every investor group from the shareholders group that represents small investors to the Council of Institu-

tional Investors that represents the large pension funds. It is opposed by the six accounting firms, as well.

So, Madam Chairwoman, I would say that this rule which is proposed as part of what I gather the accountants say generally acceptable, or accepted accounting principles, from what I have heard is about the least generally accepted accounting principle yet known to people in business in this country. That is why we really must overrule it, or urge the SEC or FASB to rescind it.

I thank you for hearing my testimony. I thank you for your interest in this bill, and I look forward to working with you in pursuit of this often invisible element to the general public which is central to our hopes for economic recovery in this country.

Senator Levin and I tossed a coin and we decided that, in light of the balance of testimony here, that he should, if I may say so, exercise his option to have the last word on the panel.

[Laughter.]

Senator LIEBERMAN. Thank you.

Senator BOXER. Thank you very much, Senator Lieberman.

Senator Levin, you have a great responsibility on your shoulders. You are going to present the opposing view to all who have spoken, including those of us here. So, please, have at it and welcome.

## STATEMENT OF CARL LEVIN, U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Thank you, Madam Chairwoman. I am not alone. There are many in the Senate as a matter of fact that concur with my view that we should not be reversing FASB. Congress should not be reversing an honest accounting rule which FASB has decided to adopt.

I was intrigued by Senator Faircloth's comments about Congress always adopting this rule or that rule. Senator I agree with you. Let's keep our hands off. Let FASB, which is a private entity created to avoid Government regulation, operate without a political intrusion which taints their process.

Congress has never reversed an accounting rule of FASB. FASB is a private group. It is a private group that sets accounting rules so that companies can follow independent accounting rules and not be politicized by Congress picking and choosing which accounting rules it wants to decide.

So I agree with the thrust of what Senator Faircloth says, although not his conclusion. His conclusion I think is that we should intervene. But in any event, the argument that the Senator makes is one I agree with.

FASB is independent accountants that are relied upon by the Securities and Exchange Commission heavily to promulgate generally accepted accounting standards.

It is those standards which the Bradley resolution would interfere with in a sense, but much less so than the Lieberman bill. The Lieberman bill would actually reverse it. The Bradley resolution urges them, FASB, to reverse it on their own.

Let me start with some commentary of Warren Buffett.

I would think he is a pretty powerful voice. He wanted to be here for this hearing, but it couldn't be arranged at a time when he was

able to make it. But he did submit testimony, and I hope every Member of the committee reads Mr. Buffett's testimony.

What he has said is that the failure to treat stock options like other forms of compensation is "the most egregious case of let's-not-face-up-to-reality behavior by executives" that he has ever seen.

Warren Buffett strongly supports the FASB honest accounting rule which would end the practice of keeping stock option compensation off the company books as an expense. That is a practice which has led me to call these stock option awards, 99 percent of which go to executives by the way not lower level employees, "stealth compensation."

Before I go into the substance of the stock option accounting, Madam Chairwoman, though, let me make a preliminary comment as to whether or not Congress should be intervening.

Let me here quote Arthur Levitt now Chairman of the SEC, who says that Congress should not be reversing a FASB accounting rule. That is the issue before us: Should Congress be reversing a FASB accounting rule?

Never been done before!

This is a private accounting group!

These are accounting experts. Their sole charge is to develop accounting principles that accurately reflect economic events.

We should not politicize this neutral process. We should not taint the credibility and reliability of financial statements, which is what we would be doing as politicians if we reversed FASB. And one final quote on this which is from Richard Breeden, who is the former head of the SEC, who has said that:

> The idea of Congress setting any specific accounting principle by statute would be (in his words) a disastrous precedent.

Second, FASB has issued a proposed rule. It is premature for Congress, in any event, to be reversing that rule or intervening since it is a proposed rule which has been published for comment.

The public has a chance to comment until the end of the year. Public hearings are then planned for 1994. Then there is going to be a field testing for a number of years of this proposal to see how it operates in the field.

What the sponsors of the resolution and of the bill are asking Congress to do is to intervene in a deliberative process. We should not do so. We should not do so in any event for the reasons I have given. But surely we should not jump the gun and intervene in the middle of a deliberative process of FASB.

Let me put a chart up here now which shows something about compensation.

FASB's rule proposes to treat stock options like other compensation, as an expense to the company.

Now as you can see from this chart, stock options are the only form of compensation today which is not treated as an expense on corporate books. The only form of compensation.

Now, other forms of compensation are performance based. Stock options is not the only performance-based source of compensation. You have performance-based bonuses, you have performance-based grants. It is compensation and it is treated as such.

There is another anomaly here too and that is that stock options are the only kind of executive pay which a company can deduct

from its taxes as an expense, but which is not required at the moment, until FASB's rule is adopted and finalized, to be included in its books as an expense. It's a tax deduction as an expense to the company, but it is not an expense on its books.

Now, come on, they cannot have this both ways, nor can Congress. It is compensation like any other form of compensation. It is deducted as an expense on their taxes as compensation.

If it is not going to be reflected on their books as compensation, then how in the name of heaven can they get a tax deduction for it as an expense? Nothing else is treated that way. Nothing. And this inconsistency has been used by a number of executives to great advantage. Read the figures. Read the figures on corporate pay in this country. Businessweek reports CEO pay rose on the average of 56 percent from 1991 to 1992. Why? Primarily due to stock options.

Compensation experts point out—and we have got charts on this, but we're not going to take the time to put too many other charts on; I do have a few more—to show the disconnect in this country between corporate pay and corporate profitability, the disconnect in this country between corporate pay and employee pay and the disconnect in this country between our corporate pay for executives and the executive pay in other countries.

If they could put up another chart for me, I just want to give you an idea to compare corporate pay in America to corporate pay in other countries.

Our corporate pay is twice as much for the same size companies as corporate pay in Germany and Japan, our main competitors. Twice as much. And there is no connection to performance. And we can provide the committee with charts about corporate performance in the 1980's going this direction, corporate pay going that direction.

Now, some people argue, wait a minute, this is performance based, this is an incentive to perform. And the answer is, there are a lot of other performance-based pay which is also an incentive to perform. Bonuses. Would any one of us seriously argue that a bonus based on company performance is not compensation? Would any one of us seriously argue that? It is an incentive for performance, it is good in that regard. We want companies to perform, Lord knows. We're all on the same side of that issue. We're interested in American corporate performance.

Would any one of us seriously argue that a bonus based on performance is not compensation, should not be reflected as an expense on the company books? Would any of us seriously argue that a stock grant based on performance should not be reflected as an expense on the company books, that it is not compensation? It is. It is. It is treated as compensation on the company books, though it is performance based. Only options aren't.

And then when that's pointed out—that other performance-based compensation is an expense and treated as such, both for tax purposes and on the company books—then people say but it's hard to estimate the value of stock options.

That becomes an accounting issue, by the way, as to how you estimate value. There are a lot of things which are very difficult to

estimate which are estimated by accountants according to accounting standards adopted by FASB, very difficult things to estimate.

But again, I urge you to read Warren Buffett's letter. He says, "In truth, we have far more confidence in our ability to determine an appropriate price to pay for an option than we have in our ability to determine the proper depreciation rate for our corporate jet."

Now, Warren Buffett's worth a few billions. He'll buy these options, he'll set the price for you, no problem. He says it's easier to set the price on options than it is to figure the depreciation of corporate assets.

Now is that for us to decide, or is that for independent accountants to decide? I'm not an expert on that. I'm not Warren Buffett, and I'm not an accountant, and neither are we. I don't know if there are too many accountants in this body.

But that's what we have FASB for. We don't have them by the way. That's what they were set up for. We didn't set up FASB, the accountant profession set up FASB.

I can guarantee you that if the problem were that these are difficult to evaluate, if that were really the problem, we wouldn't be here today. Because, then, if that's the issue, all you have to do is evaluate them when they're exercised instead of when they're given. That's an easy way to handle the evaluation problem. They become pretty certain at that point.

You're not going to hear too many people here arguing for that today. Because the representatives who are here today, trying to get us to reverse independent accounting standards, don't want these treated as compensation like everything else. They'll argue they're difficult to evaluate, but that's not the real reason.

The real reason is they want them off the books. They don't want them to show as an expense, like every other form of compensation. They want these treated differently. And the only justification as far as I am concerned that one can make from a policy perspective is that they're performance based. And we want to give incentives for good performance.

But, folks, we have other performance-based compensation that we don't treat this way. And if you are again going to give them that exemption, if we're going to intervene in a FASB accounting rule to give them that windfall, then by God there can't be a tax deduction as an expense for something which they don't treat as an expense on their books.

Now, Madam Chairwoman, I think I've probably taken more time than the chairman would like me to take. I did talk to Senator Dodd, however, about this and I believe that he was aware of the fact that I did want to spend 10 or 15 minutes and perhaps you weren't made aware of that.

In any event, I want to close with one comment. And that, again, is to read from Warren Buffett, because I know we're all very busy and we don't have a chance to read all the material that comes into our office. But his letter, which he would have liked to have testified, is so powerful on this issue that I would like to just close with a portion of his letter. This is page 3. He says:

> As the debate about option accounting has gone forward, 'sweep-the-costs-under-the-rug' proponents have argued fervently for disclosure—for the presentation of all relevant information about options in the footnotes to the financial statements, rather than in the statements themselves. In that manner, they say, investors can be

informed about the costs of options without these costs actually hurting net income and earnings per share.

This approach, so the argument proceeds, is especially needed for young companies:

They will find new capital too expensive if they must charge against earnings the full compensation costs implicit in the value of the options that they issue.

In effect, the people making this argument want managers at those companies to tell their employees that the options given them are immensely valuable while they simultaneously tell the owners of the corporation that the options are cost-free. This financial schizophrenia, so it is argued, fosters the national interest in that it aids entrepreneurs and the startup companies that we need to reinvigorate the economy.

He goes on:

Let me point out the absurdities to which that line of thought leads. For example, it is also in the national interest that American industry spend significant sums on research and development. To encourage business to increase such spending, we might allow these costs, too, to be recorded only in the footnotes so that they do not reduce reported earnings. In other words, once you adopt the idea of pursuing social goals by mandating bizarre accounting, the possibilities are endless.

Indeed, he says:

I would argue that the national interest theory is not only misguided, but wrong. True international competitiveness is achieved by reducing costs, not ignoring them. Over time, capital markets will also function more rationally when logical and even-handed accounting standards, rather than the 'feel-good' variety, are followed.

Madam Chairwoman, the resolution in the bill that you have under consideration is not limited to new companies, to small companies, to companies that issue stock to all employees, which, by the way, is two percent of the companies that use options. Two percent of the companies that use options go below upper management.

The bills before you today go way beyond new companies, new starts, new capital. The main beneficiary of this reversal of FASB, if we do it, will be large existing companies that use stock options to the extreme that they now do it because they are disguised, they are stealth compensation. They are given a treatment no other form of compensation is given, and that's the way many of the executives of those companies want to keep it, for a very obvious reason, which is that they benefit financially so tremendously from ignoring options as compensation.

I thank the Chair, I thank the Members of the committee again. I know I've taken longer than my colleagues have here, and I hope you understand. And Senator Dodd did indicate that he was happy to have me do so.

Senator BOXER. Senator Levin, I had no problem with it because you were expressing an opposite view of a number of us.

Let me just say, so everyone understands, this is a rule that FASB is considering. They are changing the way it used to be done. And this is a time for public comment on that change.

Before you leave, I would like if we could take off that green chart and just look at the other one for a minute. Because I think Senator Levin made a powerful case that stock options are the only kind of compensation that are not expensed as compensation. However, I have here a list of other types of compensation. I will read you what they are.

Interest-free loans; remuneration in kind, such as free travel for airline, train, bus, steamship employees; titles; growth in value of restricted stock during vesting period, including stock options;

growth in value of deferred compensation, payable in stock; increases in value of profit sharing accounts, 401–K plans, and pension plans; dividends on restricted stock; promotional opportunity; growth in learning experiences; compensatory time off; telecommuting; on-site day care; space-available travel on company planes, ships, et cetera; product discounts, e.g., gasoline, merchandise; personal use of company resources; frequent flier miles.

Senator LEVIN. I'm not sure I understand. It seems to me like the day care——

Senator BOXER. These are items of compensation that have value to employees but are not expensed as compensation. So to say that stock options are the only category is not accurate.

And I would be glad to give this list to you. But the point is that this would not be the only kind of compensation that would not be expensed as compensation.

Senator LEVIN. To the company?

Senator BOXER. That's my understanding.

Senator LEVIN. It's expensed. Day care is not expensed? Day care costs to the company are not expensed?

Senator MACK. Some are, some aren't.

Senator BOXER. It is not expensed as compensation.

Senator LEVIN. But it is expensed.

Senator SHELBY. It costs something, right.

Senator LEVIN. It is a cost to the company, an expense which shows up on the balance sheet.

Senator BOXER. It is not expensed as compensation, is my point.

Senator LEVIN. My point is that this has got to be expensed. All of those items that you talked about are expensed. They all show up in the company books as an expense. This is the only thing that does not show up as an expense. The point whether it is a compensation expense is a secondary issue. The point is it is an expense which is reflected.

Senator BOXER. I don't think anybody has a problem with having a footnote——

Senator LEVIN. Not a footnote, excuse me, Madam Chairwoman.

Senator Boxer. If I could respond. I do not think anyone who is on the Lieberman bill or on the Bradley bill objects to showing this straight out. But we are talking about expensing as compensation. That is what FASB is trying to force companies to do.

Yes, Senator Mack.

Senator MACK. I have a different point of view on this than Senator Levin. And I know that he started out his comments this morning kind of implying that those of us who would encourage a legislative change somehow are being impure. But I would suggest to him that the political process has already been involved in this issue.

As you well know, with a hearing that I think you held in January 1992, to lead everyone to believe that you did not use the heavy hand of political pressure, public opinion, and so forth on FASB, I think, is misleading. And what we are trying to do here is to provide some balance.

In fact, I think in your—I will just take a look at what your comments were—you were speaking to a gentleman representing FASB that day who I think is here today. And your comments to him

were you had been struggling with this for 8 years and you wanted a minimum of an additional 2 years to address the problem, which everybody agrees, everybody that we know of agrees is a problem. It is too long.

That is too long for Congress to be expected to wait when you have got a system, as we do here, which does not accurately reflect what stock options are in reality. So I am just saying that we are providing an opportunity here for those who disagree. And it was implied here that everyone disagrees, and we know that everyone does not. But there are very strong differences of opinion on this, and I certainly am going to be one of those who will support the Senate.

I say to you, Carl, if FASB does not react to that and they go ahead and continue this, I will push the legislation. And unless you're going to say to me that a FASB reverse—where the reverses are going and you're not going to pursue the legislation. Are you going to pursue legislation on FASB?

Senator LEVIN. No. My legislation had a very clearly stated purpose. It was to get FASB to do what they said they believed in, which is very different—if I could conclude—very different from reversing FASB.

Senator MACK. I know what you believe you were doing, and I have no disagreement with that.

Senator LEVIN. Stated I was doing.

Senator MACK. I have no disagreement with that. But we would all be naive to conclude that was not perceived as the Congress placing political pressure on FASB to move in the direction that you wanted them to move in.

Senator LEVIN. I agree with you on that. I agree with you, you have to be naive to believe that. But I think it is important what the "that" is in reference to. And that is that FASB, for decades, has said that the reality is that this should be treated as an expense on the companies' books. Getting them to act according to their own beliefs is very different from reversing FASB in terms of what they did.

I can give you this assurance, and I think you are raising a very fair point. If FASB tomorrow reversed themselves and said that this should not be an expense and that is their belief, you will not find me pressing a bill to reverse FASB's decision. The purpose of that bill was to get FASB to do what they believed and had consistently said they believed was the thing to do, which was to find a way to treat that as an expense.

That is the opposite here, where these bills would reverse FASB. I will not introduce a bill, I assure you, to reverse FASB, even if they decide that they're wrong and there should not be compensation.

Senator MACK. The last point I would make is that one of the comments that I think you made with reference to options, and I guess it was the exercise of options, had jumped so dramatically in 1992 over 1991.

Senator LEVIN. I was quoting, I think.

Senator MACK. The reason I think that occurred was because people were, in essence, wanting to avoid the taxes that they believed were going to be coming from the Clinton administration.

Senator LEVIN. I am glad you mentioned the name of the administration, in case anybody could forget.

Senator BOXER. Senator Levin, I want to make sure I understand, you do not think that we should legislate?

Senator LEVIN. Should not reverse FASB.

Senator BOXER. As I understand it, FASB has not made the decision to go ahead.

Senator LEVIN. Exactly right.

Senator BOXER. But you have S. 259.

Senator LEVIN. Which was before FASB acted, to encourage them to do what they said was the right thing to do.

Senator BOXER. What you are saying is that you would not pursue S. 259 no matter what FASB does?

Senator LEVIN. That is correct. At least now that they have tentatively decided, there is no more purpose to pressing them to make a decision according to their own words.

Senator BOXER. What if they change their minds and go with the status quo and do not move forward? Would you still move forward with S. 259?

Senator LEVIN. When FASB makes a decision as to what is right from an accounting perspective, that is the end of it as far as I am concerned. I don't think that we should intervene to reverse FASB. All we want them to do is to make a decision as to what is the proper accounting.

Senator BOXER. Senator Faircloth.

Senator FAIRCLOTH. Madam Chairwoman—Senator Levin, I thank you for your compliment. I don't get very many of those.

[Laughter.]

FASB obviously was not interested in this rule. They had no intention. You say they were in favor of it, but they had not done anything in years and years. Obviously, they did not intend to do anything until you hit the cattle prod to them with this bill.

Senator LEVIN. I thank you for that compliment.

Senator FAIRCLOTH. And then all of a sudden, they got excited about something and that will move a cow or most anything when the prod hits them. The congressional—and when a Senator brings the prod out, they will usually jump.

So what I said was, very simply, this movement started my legislation. And if it is necessary, we will have to end it by legislation. Your rule was exactly what I was talking about, your proposed bill, was more congressional interference in the private sector.

Now you know—I think you know that FASB would have sat on this thing until doomsday if you had not prodded them.

Senator LEVIN. I hope that is not true, but you can ask FASB.

Senator FAIRCLOTH. We know it is.

Senator LEVIN. No, I don't know it is. I have a little more confidence in FASB given their beliefs—their beliefs that they had expressed over decades that stock option compensation should be treated like other compensation. That was their expressed belief for decades. That, given their deeply felt beliefs, they would have finally done something to resolve that issue. That is my belief.

You know, you can ask FASB this morning.

Senator FAIRCLOTH. Senator Levin, if someone has believed something for decades and has not done anything about it and sat

on it for decades, what do you think the chances of them making a quick and sudden move is?

Senator LEVIN. Very slow. That's why they are test marketing this for 3 years. They are very deliberative here. They are very deliberative as to what they are doing. They have proposed something, they're getting comment on it, they want to test it, they want another year of public comment. They are going to have hearings on it, they're going to test market it in a limited area for 3 years. That is a deliberative process.

I thank you for your comment, by the way, Senator. It is wonderful to know that you can drop a bill in and just have FASB or any other private entity jump this way. It really is—I'm going to put more bills in, I tell you.

[Laughter.]

Senator BOXER. Senator Shelby.

Senator SHELBY. Senator Levin, let's go back just a minute to stock options and how they really work. Let's say there is just a small company in Michigan, California, Alabama, it would not matter where. They have limited capital, very limited capital, like most companies starting. And they pay their employees, all of their employees—they have eight or ten employees—very little money. Maybe their wives are supporting them and keeping them. This happens a lot. They grant stock options to all eight of these people in various amounts, give it to them.

That company, basically, by most accounting standards—maybe it is not even public yet—would be insolvent. I mean, those stock options wouldn't even be worth anything yet. But they have got this idea. The Congresswoman from California called it a dream, which it is, that this product that they're going to try to develop is going to work. It might not work, so many bankruptcies out there in small business.

How do you put a value on that, something that really has no value except in their head? A lot of that goes on. How do you put a value?

Senator LEVIN. The question of how you value this, it seems to me, is the same question as to how you value other things which are uncertain. And I think FASB is going to tell you how they value it.

I would urge you, though, I would urge you in this regard——

Senator SHELBY. Does it have a value? Not by accounting standards.

Senator LEVIN. Ask the accountants. I think they will tell you it does have value. If it doesn't have value, there are billions of dollars, hundreds of billions of dollars of very valuable things that are being handed out that are being fought for very hard and that Warren Buffett will buy off of them like that.

He is a better expert than I am. I never had a half a million or a quarter million.

Senator SHELBY. He is not the only person who knows something about stock options.

Senator LEVIN. I agree. But I'm just saying he is better than I am. He says it is easier to value stock options than it is how long the company plane is going to last. You ought to check with Warren Buffett as to why he says that.

I am simply saying this, Senator, if that were really the issue, if that were truly the issue that they are difficult to value——

Senator SHELBY. What is the real issue? What is the real issue?

Senator LEVIN. They are something that is worth an awful lot of money that is being given by a company mainly to executives, 99 percent of the time to executives and not the lower level employees, that does not show on the books as an expense. And therefore it is easy to hand out because it does not affect the bottom line.

Senator SHELBY. Are you basically against giving executive compensation where people really perform and lead a company?

Senator LEVIN. Quite the opposite. Quite the opposite.

Senator SHELBY. You're talking about salaries and bonuses in Europe as opposed to the United States. Are you trying to get the Government to mandate what private enterprise can pay and should pay?

Senator LEVIN. Quite the opposite. I think Government here—Senator Faircloth says that——

Senator SHELBY. It sounds like it.

Senator LEVIN. You want Government to tell a private accounting standards board what to do and what not to do.

Senator SHELBY. I want them to listen to something.

Senator LEVIN. I think they ought to listen, too. I definitely think they ought to listen.

Senator SHELBY. They are making a mistake. But this hearing process is not over with for public comment.

Senator LEVIN. In response to your question, I think what is important here is that, like other forms of performance-based pay or compensation, that this should be treated the same way. Am I in favor of performance-based compensation? You betcha. Do I like stock options? You betcha. I think they have a real place. They should not be treated the way they have been, given FASB's belief that they have value, that there is a cost to the company, and that they are compensation.

Senator SHELBY. Are you against people making big salaries or making big profits because of stock options?

Senator LEVIN. No. I just want them treated the way the independent accountants say they should be treated so that we have honest accounting standards and so that we have honest financial statements. That's my belief. I am defending FASB.

Senator SHELBY. You believe the United States should follow Europe as a model, considering what is going on over there?

Senator LEVIN. If I were a stockholder, no.

Senator SHELBY. On the executive compensation, you believe that? You proposed a chart.

Senator LEVIN. You know what I think. If we have honest accounting standards——

Senator SHELBY. Answer my question. Do you believe that? Do you believe the United States should follow the European model to compensate their executives? You proposed a chart a minute ago showing—do you believe that?

Senator LEVIN. I believe that we should follow the model that all forms——

Senator SHELBY. What model?

Senator LEVIN. The compensation model that all forms of compensation, executive compensation, are treated as an expense on the books. That's all. That's the model I want.

Senator SHELBY. But not the amount people make?

Senator LEVIN. I don't think we ought to legislate the amount.

Senator SHELBY. I hope not.

Senator LEVIN. I don't. I just think that compensation should be treated as an expense. And that's what FASB said. I don't think Congress ought to be intervening in that.

That is the only issue here because you are going to have much more honest accounting according to FASB. You are going to have much more honest financial statements, according to FASB. That is the only point. And then let the chips fall where they may.

Senator BOXER. Senator Murray, any questions?

Senator MURRAY. No. I hope that we can hear from the panel pretty soon.

Senator BOXER. We will.

Senator I just wanted to know where you got this 99 percent figure because what I have been hearing all over California, at least, is that many, many companies use stock options to pay—to the lowest level of their employees. Did you get that from some particular study?

Senator LEVIN. Yes.

Senator BOXER. Can you tell us what that is?

Senator LEVIN. Yes.

Senator BOXER. Do you want to get back to us?

Senator LEVIN. No, I can give it to you. The survey—your question is as to what percent go below top management?

Senator BOXER. Yes.

Senator LEVIN. Here is the survey. First of all, I said less than 1 percent of American companies even use stock options. That is not the question, I don't think, though. Let me get to your question. 1992 survey by the Executive Compensation Reports. That is the name of the entity which surveyed 1,100 companies and found that 2 percent give stock options to all employees. I said 99 percent. It should have been 98 percent according to that.

Senator BOXER. I thought you said only to the top. Because I think there are some who give it to all, there are some who give it to most.

Senator LEVIN. Let me quote the Wall Street Journal. The Wall Street Journal has reported that less than 5 percent of U.S. companies using stock options give them to anyone below management.

So there are two studies. One is the Executive Compensation Reports that says of the 1,100 companies that they look at that less than 2 percent give stock options to all employees. And the Wall Street Journal report that less than 5 percent of U.S. companies using stock options give them to anyone below management.

Senator BOXER. I think that is an important clarification, because when you talk about management, you talk about some pretty mid-level people, even some low-level people. So I think that is a little misleading.

In other words, you can have mid-management people who are earning maybe—correct me if I am wrong in the next panel—you know, $40,000, $30,000 and still be considered management.

Senator LEVIN. I agree with that. And I think the people you will hear from today are mainly people that do give stock options to their employees or to middle management. I think that is most of the witnesses that are on your panel.

Senator SHELBY. Why would you take that away from them? This is basically what you would do if you changed that. Because if they adopt that—if FASB adopts the rule, fewer and fewer companies are going to use this. And that could cost job creation, innovation, things that I know we're both for.

Senator LEVIN. That is the last thing I would do. The last thing I would do is to take it away from them.

I want it honestly reported. According to the independent accountants, the only way to honestly report it is to show it as an expense on their books. I do not want to take it away from them.

Senator BOXER. Senator, I want to thank you. I know it is hard to be the one to carry the opposite view just in this room today. And I appreciate that there are others who share your view.

What concerns me, coming from a State where we have a lot of people at all levels who receive stock options and startup companies who rely on stock options, is that it would be very difficult for companies to attract the kind of capital that they need to produce jobs. We know that a lot of the big established companies are retrenching and we're going to have to look at these companies to produce jobs and they need to attract the capital that is necessary.

So I think that, although we could debate an academic argument here, accounting principles, I am kind of a pragmatist when it comes to this because if I see an accounting rule that is going to go in and really hurt our job opportunities and our business opportunities, it gives me cause for concern.

I hope as a result of today's hearing, and I will call on you, Senator, that maybe there is room for us to draw some distinctions here between some of the egregious things you are worried about and some that I think are the things that I am worried about and Senator Shelby and others.

Senator Shelby.

Senator SHELBY. One thing I wanted to add, you mentioned about attracting capital. But I think just as important as capital is to attract people, young people with ideas, people getting out of school with a dream, and how are they doing it if they don't have the money to do it and if they don't have the salaries to do it. They are doing it by stock options and it is working.

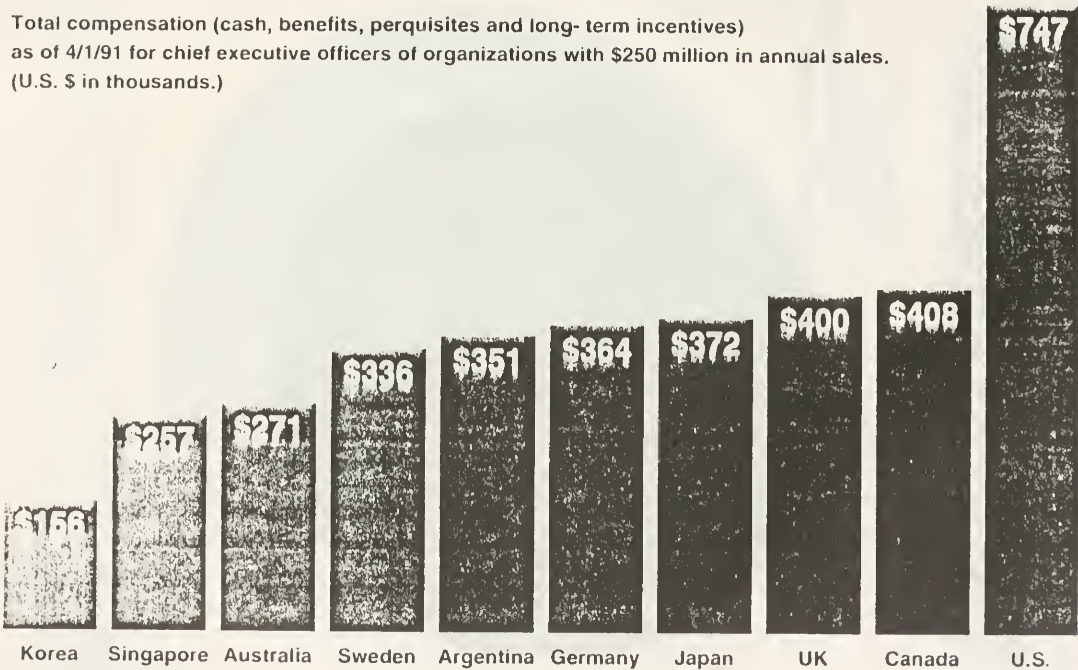
Senator BOXER. I think that is a very good point.

Senator I want to thank you and I am glad that you had the time available to make your points known. And this is not the end of this, I am sure. And we will let you go.

[Additional material supplied by Senator Levin follows:]

| ACCOUNTING FOR COMPENSATION | |
|---|---|
| Charged to Earnings As Expense | Not Charged to Earnings As Expense |
| Signing Bonus<br>Salary<br>Annual Bonus<br>Performance Bonus<br>Stock Grants<br>Performance Stock Grants<br>Restricted Stock Grants<br>Phantom Stock Grants<br>Stock Appreciation Rights<br>Health Insurance<br>Life Insurance<br>Company Car<br>Club Dues<br>Savings Plan Payments<br>Golden Parachute Payments<br>Retirement Pay<br>Retiree Health Benefits<br>Director Fees | Stock Options |

AccountingCompensation




Source: TPF&C 1991 Worldwide Total Renumeration Study, Exhibit 4

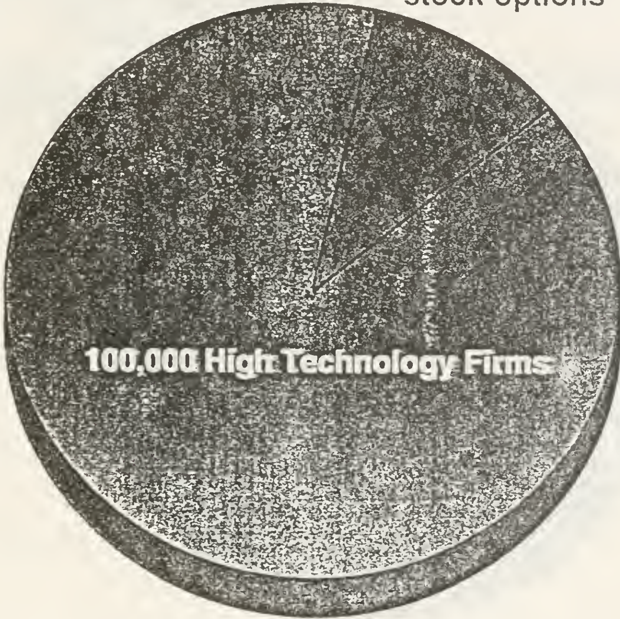
# WHY STOCK OPTION REFORM WON'T HURT THE ECONOMY

1 Number of federal corporate tax returns filed in 1990.

2 Estimate based upon 1993 SEC data on number of annual reports filed (11,150); number of pending Initial Public Offerings (800); and estimated number of companies considering filing IPOs (5,700)

283-C8a GA

## WHY STOCK OPTION REFORM WON'T HURT THE ECONOMY




Source: Estimates based on SEC & SBA data

## WHY STOCK OPTION REFORM WON'T HURT THE ECONOMY

Source. 1992 Survey by Executive Compensation Reports

TWO SURVEYS ON OPTION REPRICING PRACTICES

1993 survey by Executive Compensation Reports of Virginia of 1100 major corporations of which 112 engaged in stock option pricing

1992 survey by San Jose Mercury News of the 100 largest high technology companies in Silicon Valley of which 31 engaged in stock option repricing

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10/13/93 ECRInfo COMPANY REPORT Page: 1

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| **Affiliated Publications (PUBL & BROADCST: Publishing)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| **Albany Internat'l Corp (MFG: Textiles)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| **Aldus Corporation (OFC EQUIP: Computer Software & Svc)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 92 | | |
| **Allergan, Inc (HEALTH CARE: Drugs & Research)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| **Alexander & Alexander Svs (NONBANK FIN: Financial Services)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| **Advanced Micro Devices (ELEC: Semiconductors)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| **Amdahl Corp (OFC EQUIP: Computers & Peripherals)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| **American Medical Holdings (HEALTH CARE: Health Care Services)** | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 87 | | |
| **Ametek, Inc (ELEC: Instruments)** | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 88 | | |
| **American Greetings Corp (LEISURE: Other Leisure)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | Yes |
| **AM International, Inc (SERV INDS: Printing & Advertising)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| **Anacomp, Inc (OFC EQUIP: Computers & Peripherals)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 84 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 91 | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| **Analog Devices, Inc (ELEC: Semiconductors)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| **Apache Corp (FUEL: Oil & Gas)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| **Apple Computer (OFC EQUIP: Computers & Peripherals)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 81 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 82 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 83 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 85 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 90 | | |
| **Associated Communications (TELECOMM: Equipment & Services)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| **Autodesk, Inc (OFC EQUIP: Computer Software & Svc)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| **BB&T Financial (BANKS)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 85 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| **Bolt Beranek & Newman Inc (OFC EQUIP: Computer Software & Svc)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| **Borland Int'l (OFC EQUIP: Computer Software & Svc)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| **Cadence Design Systems (OFC EQUIP: Computer Software & Svc)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| **Caesars World, Inc (LEISURE: Hotel & Motel)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| Centex Corp (HOUSING: Construction & Real Est) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Charming Shoppes, Inc (DISCOUNT & FASHION RETAILING) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Chiquita Brands Internt'l (FOOD: Food Processing) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| Church & Dwight Co (CONSM PRODS: Personal Care) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| Cleveland-Cliffs Iron Co (METALS & MINING: Other Metals) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 91 | | |
| Century Communications (PUBL & BROADCST: Broadcasting) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Compaq Computer (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Cray Research, Inc (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 89 | | |
| Ceridian (OFC EQUIP: Computer Software & Svc) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Data General Corp (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 87 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 90 | | |
| Diamond Shamrock (FUEL: Oil & Gas) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| Eagle-Picher Industries (AUTO: Parts & Equipment) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| ENSERCH Corp (UTILITIES: Gas & Transmission) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| Federal Express Corp (TRANSPORTATION: Trans Services) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Fleetwood Enterprises Inc (LEISURE: Other Leisure) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| Flowers Industries, Inc (FOOD: Food Processing) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Forest Laboratories, Inc (HEALTH CARE: Drugs & Research) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 87 | | |
| Gaylord Container (PAPER & FOREST PRODS: Forest Prods) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Genentech, Inc (HEALTH CARE: Drugs & Research) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| Gerber Scientific, Inc (OFC EQUIP: Computer Software & Svc) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 89 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 90 | | |
| Gitano Group, Inc (CONSM PRODS: Apparel) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| General Dynamics Corp (AEROSPACE) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Hartmarx (CONSM PRODS: Apparel) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Hibernia Corp (BANKS) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| Handleman Co (SERV INDS: Other Services) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| Home Shopping Network (DISCOUNT & FASHION RETAILING) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 87 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 89 | | |
| Houghton Mifflin Co (PUBL & BROADCST: Publishing) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Household International (CONGLOMERATES) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 89 | | |
| Hudson Foods (FOOD: Food Processing) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| Humana, Inc (HEALTH CARE: Health Care Services) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| Information Resources Inc (SERV INDS: Other Services) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Intel (ELEC: Semiconductors) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 84 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| Interlake Inc (MFG: Machine & Hand Tools) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | Yes |
| J.B. Hunt Transport Srvcs (TRANSPORTATION: Trucking & Ship'ng) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 91 | | |
| Kaman (AEROSPACE) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Kellwood Co (CONSM PRODS: Apparel) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| KeyCorp (BANKS) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |

| COMPANY (Line-of-Business) / COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| Kroger Co (FOOD: Food Retailing) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 88 | | |
| Lone Star Industries (HOUSING: Building Materials) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Lotus Development Corp (OFC EQUIP: Computer Software & Svc) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 88 | | |
| LSI Logic Corp (ELEC: Semiconductors) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 82 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| M/A-COM Inc (ELEC: Semiconductors) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Magma Copper Co. (METALS & MINING: Other Metals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Mentor Graphics Corp (OFC EQUIP: Computer Software & Svc) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| Micron Technology, Inc (ELEC: Semiconductors) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Midlantic Corp (BANKS) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Herman Miller (OFC EQUIP: Business Machines & Svc) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | Yes |
| Mitchell Engy.& Develm't (FUEL: Oil & Gas) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Nortek, Inc (HOUSING: Building Materials) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| **Northrop Corp (AEROSPACE)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| **NovaCare Inc. (HEALTH CARE: Health Care Services)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| **National Semiconductor (ELEC: Semiconductors)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| **Ogden Corp (CONGLOMERATES)** | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 90 | | |
| **Olin Corp (CHEMICALS)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| **Outboard Marine Corp (LEISURE: Other Leisure)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 90 | | |
| **Overseas Shipholding Grp (TRANSPORTATION: Trucking & Ship'ng)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| **Oxford Industries, Inc (CONSN PRODS: Apparel)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| **Phelps Dodge Corp (METALS & MINING: Other Metals)** | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 89 | | |
| **PictureTel (TELECOMM: Equipment & Services)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 92 | | |
| **Policy Management Systems (NONBANK FIN: Financial Services)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| **Quantum Corp (OFC EQUIP: Computers & Peripherals)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|

* = Company No Longer Covered

| Company / Compensation Subject | Year | Terminated Year | Full Text? |
|---|---|---|---|
| Reebok International Ltd (CONSM PRODS: Apparel) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Reliance Group Holdings (NONBANK FIN: Insurance) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 91 | | |
| Salomon Inc (NONBANK FIN: Financial Services) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 82 | | Yes |
| Schlumberger Ltd (FUEL: Petroleum Services) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | Yes |
| Seagate Technology (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Santa Fe Energy Resources (FUEL: Oil & Gas) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Silicon Graphics (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| A.O. Smith Corp (AUTO: Parts & Equipment) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Storage Technology Corp (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| Stratus Computer, Inc (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Synergen, Inc (HEALTH CARE: Drugs & Research) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 88 | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| SynOptics Communications (OFC EQUIP: Computer Software & Svc) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Tandem Computers (OFC EQUIP: Computers & Peripherals) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Tektronix, Inc (ELEC: Instruments) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Teledyne, Inc (CONGLOMERATES) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| Teradyne, Inc (ELEC: Instruments) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| TJX Companies, Inc (DISCOUNT & FASHION RETAILING) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| Torchmark Corp (NONBANK FIN: Insurance) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |
| Toys "R" Us (DISCOUNT & FASHION RETAILING) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Union Carbide Corp (CHEMICALS) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 86 | | Yes |
| USF&G Corp (NONBANK FIN: Insurance) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| Varian Associates (ELEC: Electronics) | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 86 | | |
| Vista Chemical (CHEMICALS) | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 89 | | |

| COMPANY (Line-of-Business) COMPENSATION SUBJECT | YEAR | TERMINATED YEAR | FULL TEXT? |
|---|---|---|---|
| * = Company No Longer Covered | | | |
| **Wang Laboratories, Inc (OFC EQUIP: Computers & Peripherals)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 89 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 85 | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 86 | | |
| **Weingarten Realty, Inc (HOUSING: Construction & Real Est)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| **Wendy's International (LEISURE: Eating Places)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 88 | | |
| **Western Digital Corp (OFC EQUIP: Computer Software & Svc)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 87 | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 91 | | |
| **Wheelabrator Technologies (UTILITIES: Electric)** | | | |
| STOCK OPTIONS: EXERCISE PRICE CUT | 90 | | |
| **Zenith Electronics (OFC EQUIP: Computers & Peripherals)** | | | |
| STOCK OPTIONS: CANCELLED/REISSUED | 90 | | |

TOTAL COMPANIES REPORTING = 112

San Jose Mercury News • **Business Monday** • Monday, June 29, 1992

# Valley's abuse of choice is stock option swaps

BY RON WOLF
Mercury News Staff Writer

REMEMBER your childhood initiation to the world of work? Perhaps your parents offered you $6 to mow the lawn on Saturday afternoon. When the task turned out to be a lot tougher than you expected, you left half of the job undone. Fortunately, your generous employers revised the terms of the deal and gave you the five bucks anyway.

For many top executives in Silicon Valley, the world still works that way.

Often, managers who fail to perform well enough to cash in on incentives such as stock options are able to revise the terms of the deal so they can cash in anyway.

Indeed, the most prevalent compensation abuse in Silicon Valley may be the frequent repricing of stock options on terms that are exceedingly generous to executives and other employees.

Compensation specialists said that firms in Silicon Valley are far more likely to engage in the controversial "option

See *SWAPS*, Page 7D

## OPTION SWAPS

During the last two fiscal years, 31 of the 100 largest companies in Silicon Valley reduced the price that executives and other employees must pay to exercise stock options. Some of the companies had two option swaps. In most cases, the options had been issued at many different prices over a period of years. Only about one-third of the companies disclosed the average price of the old options turned in under their repricing programs.

| Company | New option price | Stock price June 26 |
|---|---|---|
| For fiscal 1991 | | |
| Adaptec | $12.50 | $21.75 |
| ASK Cos. | 4.94 | 11.00 |
| Boole & Babbage | 9.25 | 17.13 |
| Chips & Technologies | 16.00 | 7.25 |
| Chips & Technologies | 5.50 | 7.25 |
| Digital Microwave | 14.25 | 6.25 |
| Dionex | 17.50 | 28.13 |
| Electronic Arts | 8.50 | 21.50 |
| Genus | 1.25 | 2.50 |
| Integrated Device Technology | 3.63 | 4.00 |
| Intl. Microelectronic Products | 1.63 | 1.06 |
| Intl. Microelectronic Products | 0.81 | 1.08 |
| KLA Instruments | 7.00 | 8.88 |
| Lam Research | 3.06 | 11.75 |
| Maxtor | 5.75 | 8.88 |
| MIPS Computer Systems | 9.25 | 8.63 |
| National Semiconductor | 4.38 | 8.75 |
| Network Equipment Technologies | 6.63 | 11.38 |
| Octel Communications | 11.14 | 18.38 |
| Pyramid Technology | 16.50 | 11.25 |
| Silicon Graphics | 21.00 | 16.38 |
| Software Publishing | 15.25 | 12.75 |
| SynOptics Communications | 29.25 | 29.50 |
| SynOptics Communications | 17.25 | 29.50 |
| Tandem Computers | 13.25 | 12.25 |
| 3Com | 7.88 | 10.75 |
| VMX | 1.56 | 2.00 |
| For fiscal 1990: | | |
| Adac Laboratories | $0.75 | 3.00 |
| Advanced Micro Devices | 4.25 | 8.63 |
| Advanced Micro Devices | 4.25 | 8.63 |
| Altera | 10.38 | 10.63 |
| Cypress Semiconductor | 9.13 | 8.50 |
| Cypress Semiconductor | 8.25 | 8.50 |
| Informix | 5.38 | 27.00 |
| KLA Instruments | 10.25 | 8.88 |
| National Semiconductor | 7.88 | 8.75 |
| VLSI Technology | 6.25 | 7.13 |
| VLSI Technology | 4.50 | 7.13 |

Source: The companies, Bloomberg Business News

MERCURY NEWS

## ■ SWAPS

*from Page 1D*

swaps" than companies based elsewhere. The annual Mercury News analysis of executive compensation shows that 29 of the 100 largest Silicon Valley companies repriced stock options for their employees during the last two fiscal years.

Repricing of options is "not very common at all" among the country's largest corporations, said Graef S. Crystal, professor of business at the University of California, Berkeley. Crystal, who scrutinizes compensation practices by the Fortune 500, said only five or six companies in his national sample have taken such a step.

The option swaps usually occur after a period of disappointing financial performance and sinking stock prices. The repricing of options is "almost like putting money in the pockets" of company officials, said Mark Edwards, a partner at Sibson & Co. in San Francisco. The exchange "is nearly as good as cash when the price of the stock rebounds."

Among technology firms in Silicon Valley, stock prices fluctuate widely and usually recover after a sharp drop, said Edwards, a specialist in executive compensation.

### Options are linked to performance

Ideally, stock options provide a way of linking compensation to financial performance. An employee stock option is a right to purchase a share of company stock at a specified price within a stated period — usually 10 years.

Companies grant stock options to managers and other employees to provide them with more incentive and a larger stake in the success of the enterprise. When the company succeeds financially and the price of its stock climbs, the options become more valuable. Ideally, both employees and investors benefit from the arrangement.

Companies contend option swaps may be necessary to restore incentive for managers and other employees after the price of underlying stock has declined. Options to buy stock at $20 a share do little to motivate employees who can buy the same shares for $10 on the open market.

Specialists in compensation and benefits contend that the practice of repricing options violates the purpose they are intended to serve. Companies that swap options "are giving someone a raise in pay as a result of the decline in the market price of the stock," said Crystal. "That's absurd."

### Swaps eliminate risk of failure

Option swaps "undercut company arguments that they want to pay for performance," Crystal said. Many firms try to justify very large executive paychecks as proper rewards for the assumption of unusual risk. Companies that reprice options when stock prices fall eliminate the risk of failure and remove the penalty for poor performance, he said.

Crystal compared the granting of stock options to the high jump at the Olympics.

When a jumper clears a bar placed, say, six feet above the ground, the bar is raised for the next round. A jumper who fails to clear the bar is eliminated from the competition.

In the executive compensation Olympics, the effect of repricing stock options is just the opposite, Crystal said. When employees fail to clear the bar at six feet, it's lowered to five feet. If employees still crash into the bar at five feet, the company lowers it to four feet and so on, Crystal said.

Defenders of repricing invariably contend that swaps are necessary after a steep decline in the stock price to create additional incentive for employees who otherwise would not be able to profit from their options for a long time.

When the stock price falls, "the best way for the company to react is to get the price back up," said David Rynne, chief financial officer at Tandem Computers Inc. When Tandem decided to reprice options last year, the price of the stock had fallen to the point where the options "lost their motivational power," Rynne said. Many employees held options entitling them to buy stock at $19 or $20 while the shares languished at $12 or $13.

Option exchanges undoubtedly help retain employees holding options that are deeply under water — people who might be inclined to leave the firm and start over at a different company where they can get new options on more favorable terms. In companies that have suffered steep declines in stock price, it might be in the best interest of shareholders to lose those who are responsible for the poor performance, Crystal said.

In a company such as Tandem, however, where every employee gets stock options, "many of the people affected may not be personally responsible for the situation," Rynne said.

For a top executive, repricing of options could result in additional compensation worth hundreds of thousands of dollars. Overall, the cost of a substantial option-exchange program can be tens of millions of dollars.

Many option swaps "border on pilfering," Edwards said.

### Swaps often hurt investors

While repricing rewards employees, the practice often hurts investors. Whenever new shares are issued at prices below current market value, all shareholders are subjected to dilution of their holdings. Each share suddenly represents a slightly smaller slice of the company.

For example, 3Com Corp. repriced options in October 1990 after its stock declined from $13 to about $7 as a result of weak earnings. Employees of the Santa Clara company swapped 6.25 million old options with an average exercise price of $13.32 for new options with an exercise price of $7.88.

When 3Com stock recently recovered to the $13 range, those new options had appreciated by $34 million. At the same time, the company's other shareholders were no better off than they were two years ago.

Companies "shouldn't move so fast to reprice options when their stock hits a new low," Edwards said. If repricing eventually becomes necessary, option holders should be required to give up something in return, he said. They should "bear some of the risk and some of the cost."

### Two for one at Tandem

When Tandem swapped options, employees had to surrender two of their old higher-priced options to get one of the new lower-priced options.

In arranging the terms of the exchange, the Cupertino firm tried to maintain a balance between the interests of investors and employees holding stock options, Rynne said. "There has to be some give and take."

Few Silicon Valley firms engaging in swaps require option holders to make as much of a sacrifice, however.

Ask Cos. in Mountain View gave employees three new options for four old options. Informix Corp. in Menlo Park gave employees four new options for five old options. All of the other firms in the Mercury News analysis exchanged options on a one-for-one basis.

Such swaps are "like trading in an old Cadillac for a brand new Cadillac," Crystal said. It would be fairer if they exchanged the old Cadillac for a new Geo Storm, he said.

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United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

September 14, 1993

Mr. Patrick McGurn
Director, Corporate Governance Service
Investor Responsibility Research Center
1755 Massachusetts Ave., N.W., Suite 600
Washington, D.C. 20036

Dear Mr. McGurn:

I am writing concerning the issue of stock options and S. 1175, the Equity Expansion Act. Because I believe this bill is harmful to the interests of investors and business, and would reverse gains made in advancing pay-for-performance compensation of America's top corporate executives, I wanted to alert your organization to the problems with this bill and the need for stock option accounting reform.

I believe that compensation policies linking executive pay to corporate performance are crucial to American competitiveness, and I have spent the past two years trying to change federal practices that discourage this pay-for-performance link. Hearings and legislation I introduced in 1991, helped produce SEC decisions which have enabled stockholders, for the first time, to voice concerns in stockholder votes at annual meetings about how CEO pay is set in their own companies, and also required corporations to clarify the amounts and reasons for executive pay. A third major reform involving stock options, however, remains at issue.

Right now, stock option compensation is the only form of executive pay which a company can deduct from its taxes as an expense, but is not required to include in its financial statement as an expense. That's why stock options are such a popular, off-the-books method of payment of executives, and why I refer to them as stealth compensation.

As you know, the Financial Accounting Standards Board (FASB) recently issued for comment a draft proposal requiring that stock option compensation be recorded on company books as an expense. This earnings charge would not take effect,

Mr. Patrick McGurn
September 14, 1993
Page Three

corporate capital to pay for their compensation. Second, by interfering with FASB's independence and politicizing accounting rules, the bill would threaten the credibility of corporate financial statements. Third, by blocking FASB's accounting reform S. 1175 would further the market distortions associated with this type of compensation.

Stock options, which are rarely used by our foreign competitors, typically provide 30 per cent or more of the pay of chief executive officers (CEOs) of large American firms. Business Week has reported that in 1992, average CEO pay at the 365 large corporations it tracks increased 56 per cent from 1991, due primarily to stock options. Examples include one health care executive who received $127 million in 1992, of which $126 million came from exercising stock options.

A 1991 hearing before my Subcommittee on Oversight of Government Management disclosed that, in too many cases, runaway CEO pay is hurting American competitiveness by dramatically outpacing: (1) company performance, (2) the pay of other workers, and (3) the pay of CEOs at foreign corporations. Contrary to its reputation as a pay-for-performance mechanism, stock options have contributed to the problem through such pay abuses as stock option swaps and megagrants. Swaps occur when a company's stock price drops, and the company replaces worthless stock options with new ones at the lower stock price, in effect rewarding executives for poor corporate performance. Megagrants occur when a company gives an individual options for hundreds of thousands or millions of shares, so that even a miniscule rise in stock price produces huge dollar gains for the option holder. Such practices have undermined the link between stock option pay and corporate performance, while adding millions to CEO paychecks.

Federal policy has fueled the CEO pay explosion by sanctioning the accounting loophole that permits corporations to pay their executives with stock options that never appear on the company books as an expense -- despite their cost to the company.

Federal policy has also sanctioned an existing accounting bias against certain stock option plans that tie option gains to performance goals, such as requiring company stock to outperform the overall stock market before any gains may be realized. Right now, companies seldom use these

that pay their employees with stock to record a compensation expense. Stock and stock options are both company costs which should be reflected in a company's financial statements.

(4) A fourth claim is that stock options are an essential means to attract key personnel to small emerging companies that are otherwise cash poor. This is no reason to oppose the FASB proposal, however, since stock options would remain available after the proposal goes into effect, companies would still have access to this employment lure, and stock options would remain less expensive than cash compensation.

(5) A fifth claim is that stock options are an essential means for small emerging companies to attract capital. In fact, stock options allow employees to avoid contributing any capital to their companies until they exercise their options. Then, at the time of exercise, option holders are permitted to purchase company stock at a below-market value and typically sell it for personal gain on the open market, thereby diverting capital that would have gone to company coffers if the company itself had sold the stock. Stock options thus actually reduce the capital of emerging companies in exchange for retaining talented employees.

(6) A sixth claim is that stock options are essential to job creation by allowing small emerging businesses to stretch otherwise scarce capital. In fact, the vast majority of small businesses in the United States create jobs without any use of stock options. In companies that do use them, stock options may appear to be a "free lunch" when issued, but actually reduce company capital when holders cash in low-priced options on rising stock.

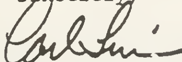
(7) A seventh claim is that many small businesses will be unable to operate profitably if they have to charge stock options to earnings. However, most small businesses do not use stock options. Moreover, to address problems that private companies might face in valuing their options -- the vast majority of small businesses are privately owned -- FASB's proposal would allow them to use a special valuation formula resulting in a lower charge to earnings.

Mr. Patrick McGurn
September 14, 1993
Page Seven

tion. Recognizing this cost will strengthen the credibility of corporate financial statements; enable company officials, stockholders and investors to gauge the true impact of stock options on company finances; and subject stock option compensation to the market discipline that comes when a company's bottom line is affected. Ending accounting rules that discriminate against pay-for-performance stock options is also overdue. The ultimate beneficiary will be American competitiveness.

I hope that your analysis of the stock option issue and S. 1175 will include consideration of these concerns. If you have any questions, please contact Elise Bean of my staff at (202) 224-3682. Thank you.

Sincerely,



Carl Levin, Chairman
Subcommittee on Oversight of Government Management

CL:ejb

Consumer Federation of America

October 19, 1993

The Honorable Christopher Dodd
Chairman
Subcommittee on Securities
U.S. Senate Committee on Banking
Washington, D.C. 20510

Dear Chairman Dodd:

As you prepare for hearings on FASB's proposed rule on stock options, the Consumer Federation of America requests that you include our strong endorsement of this proposal in the hearing record.

Adoption of this proposal would benefit investors, employees, consumers, and the entire economy. At a time when many companies are laying off workers and reducing the wages of others, dramatic increases in the compensation of many corporate executives are worrisome. That the most troublesome element in this increasing compensation -- proliferating stock options -- is encouraged by an accounting loophole is regrettable and in need of reform.

Adoption of FASB's proposal would have the following beneficial impacts: Investors would be better able to invest resources productively. More resources would be available to compensate employees and to produce products offering better value to consumers. A secondary effect would be improvements in the international competitiveness of many U.S. firms.

Just as important, the stock option-driven escalation in corporate compensation has aroused widespread moral outrage that threatens to increase worker and consumer dissatisfaction with many big businesses. In a time of rapid global economic change and increasing competitiveness, the U.S. can ill afford this increased social polarization and decreased confidence in business leaders.

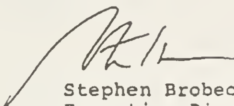
While the FASB proposal is certainly no panacea for this problem, it does represent an important step toward ensuring a

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

The Honorable Christopher Dodd
October 19, 1993
Page Two

fairer, more efficient economy. We urge the Subcommittee on Securities to endorse it.

Sincerely,



Stephen Brobeck
Executive Director

SB/lag

# American Federation of Labor and Congress of Industrial Organizations

815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000

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March 8, 1993

FILE CO...

Mr. Dennis Beresford
Chairman of the Board
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Dear Mr. Beresford:

I am writing to express the AFL-CIO's wholehearted support for FASB's tentative position that corporations be required to charge against current earnings the "fair value" of stock option grants as measured at the date of grant. We also strongly urge that the calculation of this charge and its full disclosure as part of a company's financial statements be valued according to a single standardized methodology, preferably the Black-Scholes option pricing model, so that shareholders can easily compare the cost of stock option compensation between companies.

We approach this issue from the perspective of union pension fund trustees, whose investment and proxy voting responsibilities are impacted by the quality and appropriateness of financial statement disclosure, as well as from the perspective of union members who need to be aware of the financial health and liabilities of the firms for which they work. While the majority of our more than 14 million members are participants in single-employer pension plans, Taft-Hartley plans with assets exceeding $300 billion are jointly trusteed and administered by AFL-CIO unions. In addition, officers of AFL-CIO unions represent hundreds of thousands of our public sector union members and retirees as trustees at some of the nation's largest state and municipal pension systems. In short, we represent a large community of the primary "consumers" of the information that FASB seeks to present fairly and accurately.

As I wrote in a letter to you last June 1, the rationale developed by FASB to justify a current charge against earnings for retiree health care costs pertains equally to grants of stock options which likewise represent projected future liabilities for the company. There appears to be no justification for treating executive compensation liabilities any differently than retiree health care obligations.

Mr. Dennis Beresford
March 4, 1993
Page 2

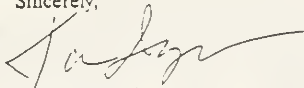
With regard to the need for standardized disclosure requirements, it is critical that investors be able to accurately gauge the present value of executive compensation packages and be able to meaningfully compare those valuations between companies and over periods of time. As compensation consultant Graef Crystal and others have persuasively argued, a FASB decision to let companies choose their own option valuation method will result in "a race to the bottom" as accounting firms compete for clients by devising methods likely to understate future cash outlays for stock option compensation. Even if companies were required to choose between a defined number of different valuation methods, the lack of a single standard would deny investors a common or meaningful yardstick by which to compare pay versus performance between companies or industries.

Finally, I would like to correct an impression that may have been left by a joint letter addressed to you (dated February 17, 1993), which was signed by a number of corporations and associations, including the Council of Institutional Investors (CII), of which we are a member. While unions of the AFL-CIO strongly support the CII's position in favor of full and accurate disclosure of stock-option related values in financial statements, we do not agree that this disclosure should be "in lieu of" any new charge to earnings for stock options. The argument in favor of fuller disclosure and standardized valuation in this context is compelling whether or not the projected liability is to be charged currently or deferred.

We also disagree with the joint letter's suggestion that calculating and disclosing stock option valuations using three different methods is superior to using some single method (e.g., Black-Scholes) that FASB would deem to be most accurate for the greatest number of companies. We fear that investors will be confused and interpret the disclosure of multiple valuations as a suggestion that the entire disclosure lacks credibility. Moreover, the use of multiple methods is inconsistent with our position that earnings should be charged currently using a single valuation standard.

Thank you for considering our views. We would be delighted to arrange any further discussions that might assist you in your final rule-making.

Sincerely,



Karen Ignagni
Director
Employee Benefits Department

Senator BOXER. I am going to call the next panel up. Shortly we are going to have some votes back to back, but until then we might as well empanel our panel and get you set up. And then when we have to leave we will. Then I hope Senator Dodd will be back.

Sarah Teslik, executive director, Council of Institutional Investors. Lisa Conte, president and CEO, Shaman Pharmaceuticals. Douglas Maine, senior VP, MCI Communications, testifying on behalf of the Coalition for American Equity Expansion.

As I call your name, please come up and take a seat.

Michael Brown, VP, Microsoft Corporation from Redmond, Washington. Professor Mary Barth, Harvard University. James Melican, executive vice president, International Paper in New York. James Morgan, managing partner, Morgan, Holland Ventures, Boston. Mr. Robert Gilbertson, president and CEO of CMX Systems, Wallingford, Connecticut. James Leisenring, vice chairman, FASB. James Bunt, vice president, GE Company, Connecticut. Dane Miller, president and CEO, Biomet, Incorporated, Warsaw, Indiana.

I think that that is a large panel. We have asked you to keep your opening statements to 3 minutes, and I know that is difficult. But it is such a large panel and we wanted to show the broadest view here so that we have a number of you here.

So if I might ask you to keep your comments to three minutes, we have the little lights there that will be working. The yellow light will come on when you have a minute left and then the red light will come on when the time is out.

If we could start with Sarah Teslik, executive director, Council of Institutional Investors, in Washington, DC.

## STATEMENT OF SARAH A.B. TESLIK, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS, WASHINGTON, DC

Ms. TESLIK. Thank you very much. Jim Morgan has graciously allowed me to usurp his identity for my remarks, so I do not have to face you sideways, since I have to leave you after my remarks.

I was told that I could have 5 minutes, but if that is not true, you can instruct me otherwise.

Senator BOXER. It is 3 minutes because of the size of the panel. Because you are representing an investor group, you do get to have 5 minutes.

Ms. TESLIK. Thank you. We rarely get any privileges, being investors.

Senator BOXER. The warning light will come on after 4 minutes.

Ms. TESLIK. First, I want to apologize. We represent millions of shareholders with hundreds of billions of pension dollars. And we, America's shareholders, are responsible for the original problem here. We are the ones who automatically voted for every compensation plan in every company, including plans that allowed stock options to be abused.

Senator Levin was one of the first to point out that excessive option awards can harm shareholders and pensioners and employees. And for this, he deserves a sincere thank you, which I am pleased to extend.

The real solution to this problem is obvious. These plans require shareholder approval. We need to support the good ones and vote against the bad ones. It is that simple.

That, however, is not an accounting problem and it must not be—and the two must not be confused. If we try to solve the corporate governance compensation problem by forcing companies that use stock options to show these transactions in their financial statements and make them both look bad and to require them to show things that did not in fact occur, we will create a problem that is much, much larger than the excessive use of stock options.

So a compensation problem has been mistaken for an accounting problem—and we have a big mess. On that front, I also need to apologize to you. It is almost certainly our fault that this seems to be one of the most misunderstood issues that I have ever seen addressed in Congress. We get calls every day from people who assume what really is going on here is that FASB has come up with an answer that we all know in our heart of hearts is the right answer, but we all have some other reason—some personal reason, some financial reason, some policy reason—to want to oppose that.

I am here to tell you that that is certainly not true for us. There are accounting reasons as well as serious and genuine policy reasons for opposing FASB's proposal. There is no group that has a greater interest in the principle of right answers to all accounting questions than we do. We are the people who invest money, real money—hundreds of billions of dollars—based on financial statements. We are not the ones who create the rules; we are the ones who rely on the rules when we put money on the line.

We are America's employees, and America's retirees, and we will not get our pensions unless our pension funds perform well based on the investments that we make, based on these pieces of paper. My average retiree's average monthly pension check is $512. There is not a lot of waffle room there. So no one will be hurt more than we will if any other agenda, however virtuous, is pursued at the expense of the accuracy and the usefulness of financial statements. This is real people's real grocery money.

I have one final apology. I am not an accountant; I am a civilian. And I can only speak in plan English on this subject, so I will only make a couple more points.

First, we agree with Senator Levin and with FASB on almost every point they make. Yet some have expressed great concern with our areas of disagreement. Much of this concern, I think, comes from a misconstruing of key points, including Warren Buffett's misconstruing of these points.

We agree that stock options have value. We believe that that value can in many cases be reasonably, although not precisely, estimated. We could agree that these options, when issued to employees, are compensation, and the cost of that compensation is ultimately borne by us, the shareholders.

We agree that compensation costs should be shown in the financials. It is alleged that we do not say that. But the only question that divides us is how should the costs be recognized.

We also agree with most of FASB's premises that they used in answer to this question. We too want information that we can understand. We want information that lets us accurately compare companies. We want information that does not cause inappropriate discrimination between types of compensation. And we want information that is accurate.

We just do not agree that FASB's proposal gives us these things. We believe there are alternatives for proposals that would. And, finally, we believe that these alternatives proposals avoid the significant distortions and inaccuracies that the exposure draft creates.

Here, in a nutshell, are our problems with FASB's proposal.

The exposure draft requires companies to put something in their financials that is not true. I realize polite people should not say this, and should not say it in Senate hearings, but I do not know any other way to make this point accurately.

Investors who read financial statements when they see a charge to earnings, have been trained to understand that that means it is reflecting an item that will at some point require payment in cash and incurrance of liability, or dissipation of an asset that could, if taken to extreme, bankrupt the company. A payment of cash can do this. A pure equity transaction cannot.

But the exposure draft requires companies to pretend that these capital transactions are cash transactions and show them as such on the income statement. Certainly, one could picture reasons why you might want to require this kind of pretending. For example, one might want these if the equity base transactions did not show up anywhere else in the financials, and this was one of the points alleged earlier. It is one of the most common misperceptions about this argument. If this were the only way that you could tell investors compensation-related events had occurred which would affect them later, then maybe you would have to pretend. But this is not the case: current financials have places where capital transactions are disclosed—and are disclosed in the way they occur—as capital transactions that cost shareholders by diluting their earnings.

Senator BOXER. Can I ask you to sum up?

Ms. TESLIK. We have tried to be very constructive in this debate. We have not tried to take pot shots as perhaps some have. We have submitted a proposal to FASB. We have tried in that proposal to address every issue that FASB has raised. We tried to do it constructively.

We believe our proposal addresses all of the concerns that FASB suggested are important. We have asked that options be valued. We have asked that they be valued with pre-established standardized methodology, and that the assumptions be disclosed, that the evaluations be disclosed as separate numbers, and that these and other key facts be highlighted so that attention can be drawn to them. We have asked that the new disclosures appear in a clear note form and that they not be transformed in any new charge in earnings.

One last observation if I may. It is important to note that the AFL-CIO, subsequent to our proposal, issued an opinion letter supplementing and agreeing with our proposal. This is especially relevant given the fact that I see circulated here today an earlier letter from the AFL-CIO, which is their former policy, which they have effectively reversed with their current policy about which I think there is no misunderstanding.

So, indeed, the AFL-CIO has taken our proposal and gone further and suggested that, in addition to our disclosure, there be an extra line on the income statement.

Thank you, Madam Chairwoman.

Senator BOXER. Thank you very much, Ms. Teslik. I want you to know that you are very clear in your explanation. As a former stock broker myself many years ago, you are exactly right. You are going to look at these charges and you are going to make a decision about the company and it worries me greatly. And I think you put that in perspective, that it is going to affect people who are counting on retirement.

I understand California Public Employees' Retirement System is one of your largest members; is that correct?

Ms. TESLIK. They are.

Senator BOXER. They want to make sure that their investments are sound and we don't want an unclean accounting system, if you will, to change people's perception of a company's worth. And I think you make that point very clear.

I am honored now to introduce Ms. Lisa Conte, Shaman Pharmaceuticals, a very exciting company that she brought from one employee to 90. I think she can give us a real sense of what this might mean if it goes into effect.

Welcome.

Is she on the 5 minute or the 3 minute? She is representing on behalf of the Biotechnology Industry Organization, so what role is she in? It's up to me? It's up to me.

Four minutes for you.

[Laughter.]

Ms. CONTE. It is just affecting the speed with which I talk.

Senator BOXER. Welcome, Lisa. We will give you a warning light when you're up to 3 minutes. Go ahead.

**STATEMENT OF LISA A. CONTE, PRESIDENT AND CEO OF SHAMAN PHARMACEUTICALS, INC., S. SAN FRANCISCO, CA, TESTIFYING ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION**

Ms. CONTE. Thank you very much for, first of all, holding this hearing on an issue that is of utmost importance, not only to Shaman Pharmaceuticals, but the entire biotechnology industry. And in particular, I want to especially thank you, Senator Boxer, for inviting me and giving me the opportunity to illustrate the impact of the FASB proposal on the entire biotechnology industry by introducing you to Shaman Pharmaceuticals.

Shaman is a young pharmaceutical company. We do all drug discovery from plants used traditionally in tropical areas. And that is, we are leveraging off the knowledge of the medicine man to come up with a more efficient route of drug discovery.

We return benefits to the cultures from which we are accessing this knowledge through a non-profit that we established called the Healing Forest Conservancy.

Overall, the process is working and in our first 24 months of operations, we moved two unique products all the way from discovery concept to human clinical trials, which is pretty remarkable for our industry.

Shaman, as you mentioned, has over 90 employees, each and every one of whom has incentive stock options in the company. And all future employees will have that. That's the philosophy and the policy of the company.

This policy creates an overall unified culture and a commitment from each employee much like the commitment any proud owner. In particular, for our mid-level and lower-level employees, options in Shaman are one of their only opportunities to own a home in the Bay Area.

For our senior level scientists, stock options in Shaman are a critical means of attracting them away from big industry and from academia into a risk environment.

Shaman is a company which was initially funded on credit cards. Later, we secured private venture capital, and finally we completed a public offering early this year. Since inception, we have raised over $70 million.

I do not expect to have any product revenues or profitability in the next couple of years. And if the FASB proposal is implemented, it will be even longer.

Therefore, implementation of the FASB proposal decreases the attractiveness of our company to investment from the capital markets, the lifeline of our company. In effect, an accounting rule change impacts the survivability of our company. More than 70 percent of the companies in the biotechnology industry utilize incentive stock options and would have the same negative impact.

In order to respond to the FASB proposed, companies like Shaman would have to make changes that would negatively impact and disproportionately negatively impact the lower-level employees in the company.

Ours is an industry that only exists in America because of the incentives that we have here in America. The biotechnology industry is already taking its lumps in the capital markets because of the uncertainty of price controls associated with health care reform. Let's not add to that.

I respectfully urge you to oppose the FASB proposal on the accounting of incentive stock options.

Senator BOXER. Thank you very much, Ms. Conte.

Next is Mr. Douglas Maine. I'm just going along with this list.

All right, Mr. Maine, senior vice president, MCI Communications. Then we will go to Mr. Morgan, Mr. Gilbertson, and Mr. Leisenring.

**STATEMENT OF DOUGLAS L. MAINE, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER FOR MCI COMMUNICATIONS CORPORATION, WASHINGTON, DC, TESTIFYING ON BEHALF OF COALITION FOR AMERICAN EQUITY EXPANSION**

Mr. MAINE. Thank you, Madam Chairwoman.

I am Doug Maine, the chief financial officer for MCI Communications Corporation. My testimony today can easily be summarized.

Although FASB's proposal is not totally indefensible in theory, it is unnecessary, it is unwanted, and it would be unusually harmful. If adopted, the FASB policy will lead to a higher cost of capital, particularly for small companies and, ultimately, of course, the loss of jobs.

It is a simple fact of life that reported earnings by companies drive stock prices. The higher the actual and reported earnings, the higher the stock price.

Employees are attracted to startup companies due to the availability of stock compensation. They bet on the come. Moreover, since small companies are often not able to offer competitive cash compensation, they must rely on stock options to attract employees.

MCI is today a company with $12 billion in revenue and, more importantly, has created jobs directly for 36,000 employees and indirectly for another 10,000. There is no doubt that, without stock options, MCI would not be where we are today. In fact, we may not even exist.

If the FASB proposal is adopted, stock prices will probably be depressed since earnings will be depressed. Now, FASB disagrees with this point, however, I submit that FASB does not have the credentials to make this judgment.

According to someone who does have the credentials, Merrill Lynch, the largest of all Wall Street firms, the FASB proposal could lead to a higher cost of capital and the inability of some firms to raise any capital at all in the public markets. And I have submitted Merrill's study as part of my testimony.

Moreover, according to a survey by Venture One of over 1,600 high technology companies, 88 percent of the firms they surveyed said that if the FASB proposal is adopted, they will reduce their use of stock options. Forty-eight percent of these companies said they would issue options only to key executives. Ten percent predicted that if the FASB rule is adopted, they would eliminate issuing options altogether.

United States companies use stock options more than foreign companies. And it provides a competitive advantage. According to Price Waterhouse, not a single other country has adopted FASB's pronouncement.

FASB says that stock options have potential intrinsic value and I certainly don't disagree with that point. However, earnings per share calculations already take into account the dilution of stock options.

According to Merrill Lynch, and I am even told Myron Scholes, use of an option pricing model such as Black-Scholes is inappropriate and does not provide an objective basis for assigning value and recording compensation expense. What is especially galling is if a company's options are never exercised due to, say, the fact that the market price never exceeds the option price, companies will not be able to reverse the charge and later restore their earnings.

The question must be asked, who benefits as a result of the FASB rule. Financial statements are prepared under FASB guidelines in order to measure performance and in order to provide investors with a consistent way of evaluating companies. The FASB proposal would certainly not benefit companies. You'll be hearing about that all morning. And I believe that it would actually confuse investors.

In closing, I don't think you can go wrong if you apply the same rule of reason here that you do on any other policy areas. For instance, we don't let economists use the economic definition of income to drive our tax policy into forcing people to pay income tax on the imputed rental value of the homes they own. Even though imputed rental value clearly qualifies as income under economic theory, we recognize that the cost of such taxes outweigh the bene-

fits in exactly the same way the costs of imposing FASB compensation theory on American economic policy far outweighs the benefits. They need to withdraw their proposal.

Senator BOXER. Thank you very much, Mr. Maine.

As you know, there are three back-to-back votes. And so I think the best way is if we take a break to 12:30 and continue the panel discussion at that time, because it's 15 minutes for the first vote, roll's 20, 15 for the next, and then Senator Dodd is expected to be back.

I just want to say, from my own personal viewpoint, this has been very instructive for me. I just hope we don't make an accounting change that's going to have a tremendously negative impact on our economy at a time when God knows, coming from California, we can't absorb any more hits.

The one area where we've had a bright spot is our high tech. And this is aimed at the heart of high tech. I would just, you know, urge our FASB representative here, in case I don't make it back because of another engagement that I had put off until after the noon hour, please to consider the real on-the-ground impact this is going to have on people and the ability of California to come back from what has been a horrible recession. I urge you to consider that.

In other words, there's one way to look at something with green eye shades. There's another way to lift the eye shades and let the light come in and see what is really happening on the ground.

I would urge you to do that. I know and believe that you will. I hope that you will. Because I don't want to see us have to get involved in the Lieberman legislation. I would prefer that that not be the alternative, although I will strongly support it if need be.

I want to thank all the witnesses and the senators who appeared. And we look forward to resuming this hearing at 12:30 p.m.

We stand adjourned until 12:30 p.m. Thank you.

[Whereupon, at 11:45 a.m., the hearing was adjourned to reconvene at 12:30 p.m.]

**OPENING STATEMENT BY SENATOR CHRISTOPHER J. DODD**

Senator DODD [Presiding]. The subcommittee will come to order.

Let me first of all thank my colleague from California, Senator Boxer, for very graciously chairing the hearing this morning. And I apologize to all of you who are here and those who have testified. I understand I had half the U.S. Senate testifying at one point or another here. There is no small amount of interest in the subject matter at all.

I am just going to take a minute, if I can, to express my own views, because I think this is very important subject matter, and then quickly get back to the rest of you. I deeply appreciate your willingness to spend as much time as you have here with us this morning.

I welcome everyone here this morning. It's a highly technical subject in many ways. But I happen to feel it has major implications for employees, stockholders, and for small and growing companies in our Nation.

Stock options have been tremendously important in building companies like MCI and Microsoft. They have created thousands of

jobs and become international competitors. They have been essential in the development of the U.S. electronics industry, the biotech industry, and other high technology industries where an entrepreneur has an idea but very little cash, where risk takers have been willing to join the company for a share of its future profits.

We tend to focus on the high technology industries, but we should also be aware of the employee stock option program of a company like Wendy's, where an assistant store manager can own a share in his company and a stake in our capitalist system.

What other nation in the world makes its workers owners to the extent we do in this country? It is, and should be, our national policy, in my view, to encourage share ownership by the largest possible group of our work force.

So this hearing today, while it is on a very arcane and technical subject, is vitally important to the American work force, to shareholders, and to the economic growth of our nation. I don't think there should be too much disagreement—at least I hope there's not—about the value of employee stock options. Even the Financial Accounting Standards Board has pointed out that the issue is not whether employee stock options are good or bad, but how to account for them in corporate financial statements.

FASB emphasizes that accounting standards should be neutral. Others have questioned whether the path FASB has chosen is in fact neutral. Companies who are testifying this morning have told us that the FASB proposal could have a serious negative impact on the ability of startup companies to attract and retain employees and on the willingness of more established companies to grant broad-based stock options to mid- and lower-level employees. They have said it will raise their cost of capital and that, in the end, it will affect their competitiveness and growth.

These companies, as well as some large shareholder groups, also make the point that accounting is not a science, it's an art. There is room for judgment. They maintain that while FASB may have gone down a logical path to arrive at its proposal, there is an alternative, logical path that is not as disruptive.

Again, I want to thank all of our witnesses for coming this morning, some from as far away as Washington State and California. Let me apologize to this panel, particularly, because of the way you're jammed in there.

We are also anxious to hear from FASB. What I am going to do to move this along, is to ask you to keep your remarks around 3–3½ minutes or so, if you can. And the representative from FASB, I am going to give a little more time to because it's fair that they be heard a little longer since most of the witnesses lean the other way. I would point out that other hearings have had hearings related to this issue where the witness balance has gone the other way.

So if you take the entirety of the record of all committees, you'll end up with a situation where everything may have been said and almost everyone will have said it.

[Laughter.]

Let me just reiterate for you that I am neutral, but I am anxious to hear what the logic of FASB is. I am not neutral at all about the tremendous influence options have in our economy. And while I am very interested in hearing the ideas that FASB has, anything

in my view that has a chilling effect on our ability to raise capital, I'm going to look at very, very cautiously.

There are a lot of other people that have different ideas up here. But I just want to express to those who are here that the burden, and it's a heavy burden, is on FASB to prove why what they are advocating is necessary to correct a problem.

So with that, let me turn to Mr. James Morgan, managing partner, Morgan, Holland Ventures Corporation, from our area of New England, testifying on behalf of the National Venture Capital Association.

Mr. Morgan, we thank you for being here. And why do I think I know what you're going to say.

[Laughter.]

**STATEMENT OF JAMES F. MORGAN, MANAGING GENERAL PARTNER, MORGAN, HOLLAND VENTURES CORPORATION, BOSTON, MA, TESTIFYING ON BEHALF OF NATIONAL VENTURE CAPITAL ASSOCIATION**

Mr. MORGAN. Well, thank you very much, Senator Dodd. It is a pleasure to be in front of your committee again. It's a few years since we were talking about another topic in this very committee.

I am a venture capitalist in Boston. And I sit on the board of directors of the National Venture Capital Association. I should point out, however, Senator, that as a venture capitalist, I do not personally benefit from stock options. As a matter of fact, I am on the other side of that transaction. Over the 25 years I've been in the venture capital business, I've participated in awarding hundreds and hundreds of stock options, and every time I do that it dilutes my interest, waters me down, reduces the amount of equity I own in the company.

Why should a venture capitalist do this? We're not philanthropists. Well, we do it because we understand that by offering stock options throughout the organization in the companies that we finance, we are achieving a bond between the employees and the capital that supports those companies that has worked the magic that has been venture capital in this country.

The effectiveness of our venture capital system is well known and is envied all over the world. And while major corporations are shrinking, all new jobs in this country have been created by risk taking and entrepreneurial activities of United States growth companies.

Intrinsic component of this venture capital process is the broad and deep utilization of stock options to incentivize the employees of these highly risky ventures to work very hard, to expend the extraordinary efforts that are necessary to build the great international corporations of tomorrow. This is the life that I lead every day.

Theorists have long attempted to achieve perfection in accounting, arguing that stock option awards which may some day convey some value to the recipient should be run through the income statement of the issuing company. For as many years, cooler heads have prevailed and this proposal has never been adopted.

The valuation impossibilities of such an accounting income charge have stopped the debate. And the alternative of full footnote

disclosure and earnings-per-share dilution have served to maintain the credibility of companies' financial statements.

Senator there is no lack of credibility of financial statements today that this proposal would address or fix. Nothing is broken.

For years, the NVCA has cooperated with the FASB process, believing that accounting practice and policy should be set by the private sector. Last winter, however, unfortunately, accounting theory became enmeshed in the political process through a set of hearings that we all know very well about. And this was a prelude to the release of stock option accounting proposals that had previously been considered and shelved. Pandora's box was open. The genie was out of the bottle, and here we are.

It is argued that American competitiveness will benefit from revised accounting. I respectfully disagree with that assertion. And I speak with the authority of someone who has been associated with the most competitive sector of our economy for all of my life. I know about competitiveness and competitiveness will not be enhanced by the proposal that FASB is promoting right now. Neither will job creation, capital formation, expansion of the tax base, or export growth.

Today, the NVCA announces its support of the Equity Expansion Act of 1993, and we thank Senator Lieberman for that initiative. And today, the NVCA announces withdrawal from the FASB task force on stock option accounting. We have reluctantly concluded, after 10 years of very, very close working with the FASB organization, that it is simply not responsive to alternative legitimate points of view.

A storm threatens our industry, Mr. Chairman, and we have been forced against our desire to come to this place for disaster relief.

Senate bill 1175 should be given every consideration as a preferable alternative to S. 259. A clear signal should be sent to the SEC that in this matter, FASB accounting standards are inconsistent with cost-benefit considerations and should be ignored. It is likely that many companies will refuse to accept the FASB proposals if they are promulgated and will accept "qualified" audit statements. And the SEC should be instructed to accept audit statements that are so qualified with regard to expensing of stock options.

I look forward with you, Senator, to a time when a proper nonpolitical process for setting accounting standards can be restored.

Thank you very much.

Senator DODD. Thank you.

Mr. Morgan, let me just say as an aside that I am sorry to hear you say you're going to drop out. I understand your concerns. I've expressed mine. But the danger you run with that approach is that when people start dropping out then people around here start looking for other ways, other than the present system we've got. People've got to stay in the game, even when we get decisions we don't like from time to time.

I've been a real advocate over the years of fighting standby authorities in a number of areas that people have wanted, because there's no such thing as standby authority in the Federal Government. It very quickly becomes authority.

I would urge people to be cautious about jumping here too quickly on an issue we may have—you and I may agree on with someone else but disagree with someone else. But it's important that we not lose FASB as an institution. There are people in this building here who will quickly come up with some alternatives that you're going to like a lot less than FASB.

Mr. MORGAN. It was a very hard decision Senator. We've studied and considered and debated. And if we felt that there was one iota of responsiveness in the FASB process to our point of view, we would have stayed.

Senator DODD. I appreciate you did not take the step lightly.

Mr. MORGAN. It was a very difficult step.

Senator DODD. Mr. Gilbertson. President, CEO, CMX Systems, constituent. As the people are from FASB. From Wallingford, CT. And we appreciate immensely your presence here and your testifying on behalf of the American Electronics Association. We're grateful to you for coming.

**STATEMENT OF ROBERT GILBERTSON, PRESIDENT AND CEO, CMX SYSTEMS, WALLINGFORD, CT, TESTIFYING ON BEHALF OF AMERICAN ELECTRONICS ASSOCIATION**

Mr. GILBERTSON. Thank you, Mr. Chairman.

The American Electronics Association represents 3,000 member companies. Over 2,000 of these member companies are small companies with fewer than 200 employees. And virtually all of those small companies and all of our large manufacturing entities rely heavily on stock options and stock purchase plans.

Mr. Chairman, I have a significant amount of expertise in accounting. I earned an MBA in corporate finance from the University of Chicago, and a Ph.D. in business from Stanford, and taught accounting at Harvard. Thus, I could spend some time talking about the theoretical aspects of this particular FASB proposal.

But I think it is more important that rather than talk about the sanctity of accounting principles, we talk about the actual issues and the impact on my company.

Yesterday was a great day for CMX. We recorded two events that probably cement our future. We are a company that has grown by a factor of 10 in the course of the last 2 years, to about a $9 million revenue rate at the current time. And yesterday we were able to both cement our second major customer, which will allow us to grow again at a very rapid rate for the next several years, and also make a very significant breakthrough in technology.

We were able to figure out and prove our technology works now to the extent that we are going into manufacturing of a laser diode that allows us to transmit very stable light waves, which we can use for measurement purposes. The entire diode has the same mass as my human hair.

So the net effect is we will be producing a very state-of-the-art product in Connecticut that will allow us to be a very competitive international company.

Senator DODD. This is the CMX Corporation, is that right?

Mr. GILBERTSON. Right.

[Laughter.]

It stands for Configuration Management Excellence.

We wouldn't have been able to attract the talent to accomplish these two objectives yesterday if we did not have stock options, or if we did not have the ability to share our appreciation potential with these employees. All 39 of our employees are holders of stock options. And, in fact, after 90 days, every employee is granted stock options ranking from the receptionist and clerical employees on up. Actually, we have no clerical employees; we're a startup company.

Basically, this is not atypical. A study done by Share Data, Inc., found that 55 percent of the 111 companies gave options to all the employees in the company.

In all four companies that I have run, three of them startups, which encompassed over 1,000 employees, every employee has participated in the stock option program. And most of those employees made a significant amount of money which they could then use for their children's education or buying homes.

The proposed FASB standard, however, would reduce the profits of this average technology company, like mine, by almost 50 percent. For public companies, this will seriously impact their share price and capital raising ability. More disastrously, this standard will impede companies like mine from going public.

Under this standard, our earnings would be less impacted. We had it calculated and it's a little over 20 percent per year. But our earnings would be more volatile. Therefore, at best, we would probably be only able to raise 80 percent of the capital we'll need to finance our continued advances in research and development, manufacturing, and in hiring the people to make this all happen. And we would also have less of a cushion during those bad times which eventually come to all companies.

In summary then, it is clear to the AEA and to my company, that the proposed FASB standard is generally accepted by no one. Options are a method of raising capital and rewarding risk. They are not current compensation.

As an entrepreneur who has grown a company to 39 employees, I will be faced under this particular proposal with not offering options, thus CMX will either not attract the right talent, or we will alienate our skilled talent when they don't share in the rewards. Or we will have to defer going public, thus restricting the amount of capital that we can invest. There by slowing our growth.

Therefore, the AEA and CMX urge congressional action. We applaud and strongly endorse legislation by Senators Lieberman and Mack, which is S. 1175, and the Senate Resolution by Senator Bradley, which is S.Res. 34. We also applaud your decision, Senator Dodd, to bring this issue to the attention of Congress and the American people, and certainly Connecticut's Congressional delegation—Senator Lieberman, yourself, Congresswoman Johnson, have been very strong behind this. We appreciate that.

Senator DODD. Thank you very much. And we always like to get a little PR work done for our Connecticut firms.

Congratulations on that good news as well.

Mr. Leisenring, who is of course, as you all know, vice chairman of the Financial Accounting Standards Board in Norwalk. And we put you right in the middle there today, Jim, so you could be physically in the middle of it and literally in the middle of it.

Thank you for coming.

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## STATEMENT OF JAMES J. LEISENRING, VICE CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD, NORWALK, CT

Mr. LEISENRING. Good afternoon. The board does welcome this opportunity to discuss accounting for stock-based compensation before the subcommittee on Securities.

You asked that our testimony address three questions. The first asked about the extent to which companies use options. We know that options are widely used as compensation, otherwise there would be little interest in how to account for them.

We also know that fixed options are used more than performance-based options, due in large part to accounting considerations rather than economic or motivational concerns. We understand that the most extensive use of stock options is in startup enterprises.

The impact of our proposal, which is the subject of your second question, will vary widely from company to company. We are conducting a field test to learn more about the financial affects on companies. Requiring expense to be recognized for fixed options would be a significant change. But our proposal would often result in less expense for performance-based options than is recognized now.

Therefore, one important impact would be to level the playing field and remove accounting as an overriding consideration choosing between fixed and performance-based plans.

Your third question on the merits of the accounting and concepts in which our proposal is based is discussed in our written submission and the remainder of my testimony.

The FASB is an independent, private sector body whose only purpose is to improve financial reporting. Leaders of the profession took steps to ensure the FASB's independence because they recognized that there would inevitably be issues for which the short term interests of some would conflict with the long run objective of relevant, credible financial reporting.

Financial statements are a basic tool used for communicating information about economic events to capital markets. An efficient economy requires financial information because investors, creditors, regulators, and others base decisions on information contained in financial statements. To make the best economic decision, those decisionmakers must have financial statements that neither omit information, nor color the message to influence behavior in a particular direction.

Some people say that we should consider the perceived economic consequences of our standards. They contend that we should not act if a new accounting standard might have an effect that they consider undesirable. Such comments may at first seem plausible when made in the name of job creation, United States competitiveness, and encouraging startup businesses. But pursuing economic goals by slanting the message contained in financial statements would succeed only in impairing their usefulness and credibility. Costs exist whether or not we recognize them in financial statements.

We believe that economic goals are best achieved directly, by subsidies, tax policy, and the like. Capital markets, on the other hand, are best served by unbiased financial statements designed to

inform policymakers rather than to promote policies. Decisionmakers need financial statements that tell it like it is, in short.

Despite what you may have heard, and I have heard several of you assert this morning, we are reconsidering current accounting for stock compensation because our constituents, including the AICPA, the SEC, and most of the major public accounting firms and several corporations asked us to, not because of political pressure. They told us that transactions with substantially the same economic effects often receive drastically different accounting treatment under the current standards.

We agreed that the current accounting for stock compensation is biased, lacks credibility, and therefore requires improvement. With the exception of fixed money employee stock options, all other transactions which equity instruments are issued are recognized in financial statements. Moreover, all other forms of compensation, including salaries, pensions, restricted stock, health care benefits, are measured and recognized as costs in financial statements. Have we made up our minds that stock options are compensation that should be recognized? Yes. Have we made up our minds about exactly how to measure that compensation expense? Emphatically no.

This is the third time in the past 50 years that an accounting standards setting body has considered stock compensation. We have agreed with our predecessors that stock options granted to employees are compensation. Our predecessors reached that conclusion. We have concurred with that.

Debate, however, has been and continues to be how to measure the compensation. We encourage continuing debate and research on measurement. Our proposal acknowledges that employee stock options are different from traded options, because employee options are nontransferable, usually have vesting requirements, and their terms are generally longer.

We have adjusted for those differences in the estimates of fair value to be made under our proposal. We would be delighted if continuing debate results in better adjustments that accomplish an acceptable measurement objective.

Due process for this project is far from complete. We provided for a 6-month comment period ending December 31. We are taking advantage of that time to field test the proposals and talking to scores and scores of people. In

March 1994, we will hold public hearings to hear more from interested individuals and groups.

After the board members have read the comment letters, studied the results of the field tests, listened to public hearing testimony, we will once again redeliberate all of the issues in the exposure draft and reconsider all of our earlier decisions based on the information that we have received. We urge you to accept the broad objective of credible, reliable financial reporting and allow the process designed to achieve that objective to proceed.

Thank you very much. I will look forward to your questions.

Senator DODD. Thank you very, very much for your testimony.

Michael Brown, Vice President, Finance and Treasurer, Microsoft, Redmond, Washington, testifying on behalf of the NASDAQ Stock Market.

**STATEMENT OF MICHAEL W. BROWN, VICE PRESIDENT, FINANCE AND TREASURER, MICROSOFT CORPORATION, REDMOND, WA, TESTIFYING ON BEHALF OF NASDAQ STOCK MARKET**

Mr. BROWN. Thank you, Mr. Chairman.

I am an accountant and treasurer of Microsoft. I am here today on behalf of the employees of Microsoft and the 4,300 companies of NASDAQ, the stock exchange upon which 45 percent of American equities trade every day. I am here to speak out against the FASB proposal on stock options.

At Microsoft, 100 percent of our employees can participate as owners in our company through stock options—from the loading dock, to the manufacturing floor, to the board room. And many, many other NASDAQ companies have wide-ranging stock option plans, including companies like Apple, Borland, Lotus, Novell and Sun Microsystems, to name just a few.

The FASB proposal will be bad for these already successful companies. But worse, it will be bad for American's startups because these companies, without balanced stock option reporting, will have little choice but to return to a model of the past, a model in which a wealthy few own America's companies, and our vast entrepreneurial work force is limited to receiving only wages.

The FASB proposal is bad for shareholders, bad for employees, bad for competitiveness, and bad for American jobs. But you may say, we have heard that this proposal is good accounting.

Let me here say there is no accounting, there is no theory, there is no logic that can make good that from which so much bad results.

Senator DODD. What do you do on Saturdays and Sundays?

[Laughter.]

I want to go to that church.

Mr. BROWN. Senator, when your employees are also your owners, you have to lead them. You can't just tell them what to do.

Senator DODD. I'll tell you, I'm going to work for Microsoft.

Mr. BROWN. Mr. Chairman, this proposal is extreme. Under current rules for accounting, there are a wide variety of options. Some of these options are treated as wages, some are treated as the contribution of human capital. Wages are expenses, capital contributions are not. A rule so extreme that any option likely to be issued must be considered only wages is not balanced.

This rule is inconsistent. Today, an entrepreneur who starts a new company and the one hundredth employee of an existing company (the employee who receives stock options), have equivalent opportunities to own part of America. With this rule, they won't.

And this rule, Mr. Chairman, is bad accounting. It involves a speculative, endless loop where speculation about future stock performance is recorded in historical measures of past performance. This speculative loop is not new. Speculative accounting was popular in the 1920's, but the bubble burst. Respected accountants of the day attributed the crash that followed to endless loop accounting.

In 1986, the endless loop returned with a similar FASB proposal for stock option accounting. Then as you well remember came

Black Monday. Some thought 1929 had returned. But it was true only in American accounting circles.

Had the FASB's rule then been applied on Black Monday, those companies with plummeting share prices would have reported incredible gains. Based on this event, that proposal died.

Today, we have a new twist of the endless loop. In this loop, speculation about future success becomes an asset on the books of America's corporations. But when those stock prices decline, as inevitably they will, American companies will be forced by current wise accounting regulations to write those assets off just like a bank writes off a bad debt.

Mr. Chairman, the loop was flawed in 1929, the loop was flawed in 1986, and the loop is flawed today.

This Congress, in its wisdom, in 1933, gave us the SEC to protect America's financial investors from the endless loop. Today, I ask you, extend that protection to America's workers.

Senator DODD. Thank you very much, Mr. Brown. I'm tempted to say amen.

[Laughter.]

Mr. Bunt is the vice president, comptroller of General Electric Company. Again, it looks like an all Connecticut day here. And from Fairfield, Connecticut, obviously, testifying on behalf of the Financial Executives Institute. And we thank you for coming.

## STATEMENT OF JAMES R. BUNT, VICE PRESIDENT, COMPTROLLER OF GENERAL ELECTRIC COMPANY, FAIRFIELD, CT, TESTIFYING ON BEHALF OF FINANCIAL EXECUTIVES INSTITUTE

Mr. BUNT. Good afternoon.

First, do employee stock options have value? Our answer is simple. We hope so, and so do share owners. Share owners want employee interests aligned with their own interests when they approve option plans.

Once granted, employees and share owners enjoy the same potential rewards from stock appreciation. And if the 12,000 GE employees who hold options realize gains, share owners realize even bigger gains, over some $70 billion at GE in the past 12 years.

The value given up by the share owners is already measured by dilution. And that dilution is already fully accounted for.

What is the expense to the company? Actually, the company receives cash when employees exercise options. Nevertheless, the FASB proposes to measure a company expense, even though share owners have granted employees the right to participate in stock appreciation. They would measure this expense with an accrual, based on untested and unproven adaptations of traded option models. Accruing this hypothetical expense makes about as much sense as accruing hypothetical profits once an order is received.

The FASB makes this proposal even though the company has no cash outlays, ever, and even though these options are illiquid and subject to so many variables that no credible quantification method exists.

Where are we now? Well, 20 years ago the American Institute of Certified Public Accountant members established the rules. And they knew about angels on the head of a pin. Their decision, the

only credible estimate is in an option's intrinsic value, and that's zero for options granted at the market price of the stock.

How has this worked over the last 20 years? As a preparer of our financial statements, I know that not one share owner, securities analyst, or member of the business press has ever suggested that GE's financial statements are misleading as a result of our accounting for employee options. Also, as a user of financial statements, sitting on the board of GE Capital and as a member of GE's pension investment committee, I rely on financial statements. Stock option accounting, quite simply, is not a factor.

Nevertheless, seven theoreticians at the FASB see an appalling problem. Let me quote from page 24 of their 100-page document:

> Useful comparisons between entities of profit margins, rates of return, income from operations, and the like were impossible.

And in the introduction, they also state that existing accounting, "produces financial statements that are neither credible nor representationally faithful."

This is an outrage. They have implied that there has been a 20-year period during which GE's financial position and results of operations have been misrepresented, yet only they have been astute enough to discover this.

Is the FASB answer more credible and less confusing than what we have now? I think not. Under FASB's proposal, nearly bankrupt companies could create phantom equity by issuing employee stock options. Certain S&L's would have loved this accounting.

Further, crazy as this may sound, unexpectedly strong stock appreciation will allow highly successful companies to later reduce expense and further increase their earnings. On the other hand, unexpected poor stock performance will force already unsuccessful companies to later increase expense and decrease their earnings.

Bottom line on this issue, someone should tell the FASB to put their pencils down.

Senator DODD [Presiding]. Professor Mary Barth is a Professor at the Harvard University and is testifying on behalf of the American Accounting Association.

Do you have my niece and nephew as students, the Bonanos?

Ms. BARTH. Not in my sections.

Senator DODD. I should have called ahead of time and checked.

## STATEMENT OF PROFESSOR MARY E. BARTH, HARVARD UNIVERSITY GRADUATE SCHOOL OF BUSINESS, BOSTON, MA, ON BEHALF OF THE AMERICAN ACCOUNTING ASSOCIATION

Ms. BARTH. Mr. Chairman, thank you for inviting me to testify today on the subject of stock-based compensation. I first want to apologize. I have laryngitis and I am going to do the best I can.

I represent the Financial Accounting Standards Committee of the American Accounting Association, which is a national professional organization of accountants, largely academic accountants.

The committee is charged with responding to documents issued by standards setters relating to financial reporting. The comment letter that we issued to the Financial Accounting Standards Board on their Exposure Draft, "Accounting for Stock-based Compensation" is attached to my statement.

To summarize the comment letter, the committee strongly supports the FASB's conclusions that stock-based compensation be recognized in financial statements as compensation expense.

Today I would like to briefly comment on three issues.

The first is the appropriateness of recognizing an expense for stock-based compensation.

The second is the alleged potential effects of adopting the FASB proposal on American companies and their competitiveness.

The third is the role of Congress in setting financial reporting standards.

First as regards expense recognition for stock-based compensation, we believe that all forms of stock-based awards to employees represent compensation and should be recognized as such.

Such awards differ from other types of compensation only in form, not in substance. Under current accounting rules, an expense is recognized for most forms of employee compensation—including some forms of stock-based compensation such as variable stock plans—but is not for others—stock options, for example, whose exercise price equals the option price at the grant date.

Implementation of the FASB's proposal would resolve the inconsistency among various forms of stock-based compensation and make the accounting for stock-based compensation consistent with that of other forms of employee compensation.

Recognizing compensation expense requires measuring it. Some have asserted that difficulties in measuring the value of stock-based compensation, particularly stock options, make recognition ill-advised.

The committee acknowledges that measurement issues exist. However, it does not believe that such issues are sufficiently insurmountable that recognizing zero expense is a better answer.

Many accounting measurements already reflected in financial statements involve significant judgment. For example, liabilities for pensions and post-employment benefits, loan losses, warranty accruals, and even the depreciation of fixed assets.

Dealing with measurement issues is not new to financial reporting.

Methods for estimating the value of stock options granted are based on option-pricing theory. Although this theory may not be well understood by unsophisticated investors, it is the basis for a significant fraction of the transactions in our financial markets.

The FASB recognizes that existing option pricing models do not address explicitly employee stock options, and thus the models must be adjusted to accommodate employee options' peculiar characteristics.

The question is not whether this can be done perfectly, but whether it can be done sufficiently well to enhance the relevance and reliability of financial statements beyond the current measure of zero.

The committee believes that it can. The current accounting standards for employee stock options was written over 20 years ago, and before Black-Scholes and other option pricing models were developed.

The sophistication of our financial markets reflects the technical advances in the options area since that time. We believe it is time for financial reporting also to reflect those advances.

Second, regarding the effects on American companies and their competitiveness: There have been a number of instances in the past when it had been asserted that a proposed FASB accounting standard would harm the American economy in some way. The most recent example is accounting for post-employment benefits other than pensions. Others include expensing research and development and accounting for leases. Yet, the predicted devastating effects were never realized.

Changing financial reporting standards does not change the economics of existing transactions. It only causes them to be reflected in the financial statements. Accordingly, the committee is unconvinced the adoption of the FASB stock-based compensation proposal will have adverse effects on the competitiveness of American business.

There is a large body of research that shows that our financial markets process publicly available information extremely efficiently. Thus, it is reasonable to assume that investors and creditors are already assessing the effects on firms of stock-based compensation.

To the extent that the recognized expense is in accord with such assessments, there will be no market effect. To the extent that the market is not knowledgeable about all aspects of the stock-based compensation and these become better understood when the FASB's proposal is implemented, there may be market effects.

However, even if the value of some firms decline on such disclosure, one should not conclude that the disclosures adversely affected American competitiveness.

Efficient allocation of capital resources is critical to long-run economic success, but efficient allocation cannot be obtained without adequate information. If resource allocation shifts upon availability of more information, it is reasonable to assume that the shift is toward efficiency, not away from it.

It is important to understand that recognizing compensation expense related to such plans in no way negates the incentive benefits they create. It merely measures the cost.

I have one last comment regarding the role of Congress in setting FASB reporting standards.

The standard-setting process in the United States has resulted in arguably the best financial reporting standard in the world.

Our committee is extremely concerned that the passage of this legislation as it relates to financial reporting will result in setting a precedent that could seriously undermine our current financial reporting system. The FASB's deliberative process is extensive, open, and inclusive.

History shows that they solicit advice from knowledgeable sources and often adjust their preliminary views based on input received before issuing a final standard. But the process is not complete as regards accounting for stock-based compensation. We believe the FASB should be allowed to complete it without interference.

Thank you very much.

Senator DODD. Thank you very much.

Dr. Dane A. Miller, president and CEO, Biomet, Incorporated, Warsaw, IN, testifying on behalf of the Association of Publicly Traded Companies.

**STATEMENT OF DANE A. MILLER, PH.D. PRESIDENT AND CEO, BIOMET, INCORPORATED, WARSAW, IN, TESTIFYING ON BEHALF OF THE ASSOCIATION OF PUBLICLY TRADED COMPANIES**

Mr. MILLER. Thank you, Mr. Chairman.

I represent both the Association of Publicly Traded Companies and Biomet here today. We at Biomet are a 16-year-old company with revenues in the range of $400 million. We believe strongly in stock options.

To answer the first question posed in your letter: We apply stock options to 100 percent of our employee base in the United States. In fact, several years ago, in excess of 10 years ago, we pioneered some concepts for defining "key employees" as established by the ISO Standard as "all employees who had been with the company more than 5 years."

Over the past 16 years, as CEO and president and co-founder, I am the only employee who has not received and don't currently hold a stock option in the company.

The majority of small companies, small- to medium-sized companies represented by APTC, operate with similar philosophies and they issue stock options to most, if not all, employees.

I think one has to keep in mind as we look forward that small- to medium-sized growth companies in America will be the employers of the 21st Century.

Some dislike, even resent, the concept of rewarding the disenfranchised American worker with shares in his company. In my opinion, this is capitalism and free enterprise at its best.

It needs to be pointed out that global competition by America's small- to medium-sized companies who issue stock options will be affected by this FASB rule change.

We should keep in mind that nearly all options granted by APTC companies, and most companies in America, are granted in fact at market value, and this market value does take into account an expectation for growth and success in the future.

The impact of this FASB rule change on most companies will be to limit the number of stock options issued to lower level employees and concentrate the issuance of stock options to those employees who can have the greatest effect on the future of the company.

No formula—the Black-Scholes model or any other—can predict a company's financial performance, and therefore can predict a company's share price performance.

I used to be a scientist. These formulas for a variety of different option valuation techniques I have looked at very carefully. They have been created, not derived, and their only test has been empirical.

I have heard it argued that Black-Scholes and other models of this type is the best there is. Well, if fortune telling was the best way to predict the future, we would certainly not run our lives on the basis of what a fortune teller told us to do.

This attempt to make accounting records more fair and accurate will in fact make them more confusing and unfair. This new ruling once again will affect the competitiveness of today's small- to medium-sized companies.

The APTC fully supports the Lieberman-Boxer-Mack bill.

If Congress, the White House, or the American people think stock options are a hidden form of over compensation or stealth compensation, as we heard this morning, for today's corporate executives, let's put that card on the table.

Clearly that is not the case, but certainly we don't need a bizarre accounting rule back door which doesn't make sense. Thank you.

Senator DODD. Thank you very much.

Our last witness, and we thank you for your patience, is James Melican, executive vice president, Legal and External Affairs—I guess?

Mr. MELICAN. That is right, Senator.

Senator DODD. —International Paper.

Mr. MELICAN. And also a constituent of yours.

Senator DODD. You travel back and forth across the line, then, I guess.

Mr. MELICAN. As you know, it is not very far.

Senator DODD. Not at all. Thank you for——

[Laughter.]

I like the name of the town, too. "Purchase," New York.

Mr. MELICAN. Right.

Senator DODD. —testifying on behalf of the National Association of Manufacturers.

Thank you, and thank you for waiting.

## STATEMENT OF JAMES P. MELICAN, EXECUTIVE VICE PRESIDENT, LEGAL AND EXTERNAL AFFAIRS, INTERNATIONAL PAPER, PURCHASE, NY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. MELICAN. Thank you, Senator.

Well, since I am last on the list, I am going to depart from the prepared text I have which, in any event has been filed and just try to make some comments that are responsive to points that have been raised.

First, I am here representing NAM. As you know, NAM is an association of 12,000 manufacturing companies in the United States. Seventy-five percent of that number have less than 500 employees. So 9,000 member companies have less than 500 employees. On a percentage basis in the NAM, very few of the companies are high-tech companies.

Our members are all sizes and do utilize stock options as a means of giving employees at varying levels a stake in the company.

This morning we were shown during Senator Levin's presentation a chart which said that less than 1 percent of all U.S. corporation issue stock options. I would suggest to you that that is a very misleading chart, because the denominator appears to me to include all corporations in the United States regardless of whether or not they are publicly held. Obviously if you do not have any stock, you do not issue stock options.

I had the opportunity myself several years ago to work for a $4 billion company that was not publicly held, and they felt that they were at a severe competitive disadvantage in that they could not offer stock options as an important means of attracting and retaining the kind of talent that they needed to run that company.

Senator DODD. Do you have any idea what percentage of publicly held companies issue stock options?

Mr. MELICAN. I don't have the number, but I will suggest that by going to NASDAQ and the New York Stock Exchange——

Senator DODD. I am sure it is easily available. I just thought you might have it.

Mr. MELICAN. To talk about 1 percent I think clearly is not right. I will use some specific examples, because again we heard a good deal this morning about stock options essentially going to the top management of a company.

I will discuss specifically and very briefly three of the members of NAM.

General Mills just last month had a new stock option program approved by its shareholders which provides for options going to 120,000 people in the company. That is one of the companies. Wendy's has been referred to a couple of times this morning.

In General Mills, the stock options go down to the level of the manager of the Pizza Hut that is on the corner. It is the same way with Pepsico, for the Taco Bell Chain.

NINEX, not too far from where you live, Mr. Chairman, has 75,000 employees and a stock option plan that extends to all of them. The question that has been raised is: Will these programs be maintained regardless of what FASB does?

The NAM took a survey of its 1,000 largest members. Fifty-two percent responded that they would either eliminate their stock option plan, or limit the number of people involved in it if the FASB proposal were adopted.

We heard a suggestion just a moment ago that this is the "chicken-little" argument again. The suggestion is that corporations always make these arguments; yet FASB proposals get adopted, and nothing changes.

I can personally tell you that that is not the case. When FASB adopted the standard for post-retirement health benefits, the company I work for eliminated post-retirement health benefits for new employees. That affected a lot of people, but essentially we didn't want to take the ongoing annual charge against earnings.

We were asked to comment on what's wrong with the FASB proposal. I guess I start with the old saying that "if it ain't broke, don't fix it." There is already an established accounting practice. FASB is proposing to change it. The current accounting practice works. There is no clamor from any segment of the financial or investing or regulatory community to modify it. There is plenty of existing disclosure.

Anyone who has read a proxy statement since the new SEC regulations were adopted last year, and anyone who has been involved in any discussions concerning what is going to happen as a result of the tax bill that passed just last August, realizes that there is going to be an increasing degree of disclosure regarding stock options. And as one of the previous witnesses suggested, anyone who

is interested in this information can readily obtain it. It is all there. In fact, it is all there in a form that has almost become counter-productive because there is now so much text.

The Black-Scholes formula, which again we have heard a lot about today, simply doesn't work.

The Business Roundtable did a survey about a year ago. The one thing that the survey conclusively proved is that the Black-Scholes formula is never right. The data that is available that corporations would be putting out would be wrong. It would be misleading. If we were to do it in any other context, we would have a Rule 10(b)(5) lawsuit the following day.

We have talked a great deal about the FASB proposal, and I think we need to put it in context.

At any one point in time, FASB is a handful of people. The members of this body spend most of their lives searching for a consensus, trying to find a place where most segments of the community would come together and say "that's right."

FASB has not done that. If anything, there is a total lack of consensus between FASB and all its constituencies. If there is any consensus, it is that they all oppose FASB.

If we are going to embrace the concept of generally accepted accounting principles, they ought to be generally accepted and this one definitely isn't.

Somebody once said that war is too important to be left to the generals. Stock options are a very important component of the U.S. economy. They have worked. They have worked for a lot of people. I think they are too important to have a handful of accountants as the ultimate decision makers as to whether or not they ought to be allowed to continue in their present form.

Thank you.

Senator DODD. Thank you very much.

Let me just follow up my question to Mr. Melican and ask each of you what percentage of your employees have stock options. Then I would like to know, since so many of you represent industries, what percentage of your industries use stock options, if you can answer that question. Do you know, Mr. Morgan?

Mr. MORGAN. I would say that stock options are virtually used in 100 percent of the venture-backed companies that the National Venture Capital Association supports. Typically the penetration of the stock option program entering the employee ranks ranges from 100 percent of the employees to probably 70 or 80 percent of the employees at the low end.

Ms. CONTE. Speaking on behalf of the biotechnology industry, which is well over 1000 companies both public and private, 70 percent of the companies utilize employee stock options. Fifty percent of them are using them for every single employee all the way down to the lowest level person in the company.

My company personally, as I mentioned earlier, utilizes them for every single employee.

Mr. GILBERTSON. Speaking on behalf of the American Electronic Association, we have a chart behind Lisa that shows a survey we had done of 111 companies. Fifty-five percent of the companies issued to all employees—that's every employee—right down to the

clerical, and virtually 100 percent of the companies issued stock options.

My company and the three other companies that I have been CEO of, all issued stock options to all 100 percent of the employees generally after 90 days.

Senator DODD. Mr. Maine.

Mr. MAINE. Speaking on behalf of MCI, 4,500 of our 35,000 employees receive stock options. I might also add that approximately 90 percent of all employees participate in the employee stock purchase plan, which none of us I think today has mentioned, but it is also subject to this ruling, as well.

Senator DODD. You mentioned Microsoft. How much is included?

Mr. LEISENRING. FASB does not issue stock options, but it would be interesting if we did.

Mr. BROWN. Maybe they should.

[Laughter.]

Senator DODD. It would be interesting if you had.

[Laughter.]

Mr. BROWN. Maybe we should make our contribution to the Standards Board in stock options. That might be an interesting twist.

At Microsoft, 100 percent of our employees are eligible for stock options. And the names of software companies that you know and read about, to my knowledge virtually all of those have very wide option plans.

I sit on the CFO committee of the Software Publishers Association, which has a large number of very small software companies, and many, many many of those companies have very extensive stock options plans. I don't know the exact number off the top of my head.

Senator DODD. Mr. Bunt.

Mr. BUNT. Yes. I represent—I am representing FEI. That is 8,000 companies. I do not have their statistics. I do not have precise General Electric statistics.

Senator DODD. Why don't you get those for us?

Mr. BUNT. But we have got more than 12,000 optionees, and I will get it. It is probably around 25 to 30 percent hold options.

Senator DODD. OK.

Mr. MELICAN. Obviously I can't give it for the 12,000 members of the NAM—but in the case of our company, it is about 20 percent of our salaried employees.

Another point that needs to be made, we talked this morning about the chart that showed only 2/10ths of 1 percent of major firms issue stock options to all employees, I would point out that, in a heavily unionized company like ours, stock options would be a subject of mandatory bargaining, and therefore they typically do not go to unionized employees. Those employees, however, do participate in our stock purchase 401K program.

Senator DODD. Mr. Miller.

Mr. MILLER. The Association of Publicly Traded Companies recently conducted a survey. Of those companies who responded, 98 percent use stock options. Furthermore, 60 percent of the companies which responded use stock options for every employee.

Senator DODD. OK. That is very, very helpful.

Mr. MILLER. That information has been provided as a part of and is included in my testimony.

Senator DODD. A lot of you did that. And to the extent that I have asked a question here that was not included in your testimony regarding those particular numbers, I will give you a chance to go back, if you did not include it, and make sure that the numbers are accurate.

Let me play a little bit of the devil's advocate here.

Warren Buffett, who wanted to be here today and could not because of a scheduling conflict, takes a very strong position opposite almost all of you here and agrees with FASB.

He says:

> If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? If expenses shouldn't go into the calculation of earnings, where should they go?

Who would like to answer Mr. Buffett's question?

Mr. LEISENRING. I already have.

Senator DODD. Not from you. Mr. Bunt, why don't you take it?

Mr. BUNT. Well, you would have to get into a longer discussion with Warren because, interestingly, the FASB proposal is attempting to put a value at the grant date. They agree with us, and most of the other companies and everybody else, that any appreciation after grant date you are a partner with the share owners and aligned with them, and that is not part of the compensation. So I am not sure that Mr. Buffett would even be satisfied with what FASB has come up with, but that is theoretically correct where they stand, and we agree with that point.

You get down to the point of what I said at the very beginning. It is in valuing this number. Can you value it, or can't you, reliably?

These adaptations of Black-Scholes and other models and methods just are basically nonsensical. There are lots of items in accounting contrary to what Mr. Buffett said that are not estimable and are just disclosed.

For example, whenever we get lawsuits of $100 million, $1 billion, this or that, the accounting rules say if you cannot estimate the amount, but it could be material, disclose the contingency. This is pretty much the same kind of a situation.

You can't precisely pick with any reliability the value. So 20 years ago the AICPA when they ruled it, they said, look, we cannot come up with a value. People now are looking at mathematical models to somehow explain—I think you have got a chart up there——

Senator DODD. Put that chart up.

Mr. BUNT. —some way how I disclose to my shareholders in our annual report what variables I put into there to come up with a number, and how it ever gets audited or anything. Then, in the end result of all of this, it is just a pencil transaction. It does not mean anything. It adds more complexity and less credibility to our financial statements.

So I would love to be able to write a letter and respond to Mr. Buffett, to his letter.

Mr. LEISENRING. Mr. Chairman——

Mr. BROWN. Mr. Chairman, with all due respect to Mr. Buffett, there are two types of capital: financial and human. Mr. Buffett is a famous financial investor, an investor of financial capital.

In this debate, if you believe that all capital is financial and America's workers should be workers and receive wages, and any gain that they have from whatever source in any way associated with their participation with the company is wages and compensation, then you will fall on the side of this argument with Mr. Buffett and with the Financial Accounting Standards Board.

If you believe in the great partnership of America where there is both human capital and financial capital, and you believe that America's employees can also be owners and that when they put their lives into these companies they are risking their futures along with financial investors risking their money, then you tend to fall on the side of this argument that favors giving those same employees an opportunity to be owners in those companies.

Senator DODD. But how do you stand on the family and medical leave bill?

[Laughter.]

Mr. BROWN. Pardon me?

Senator DODD. I was only——

[Laughter.]

Let me ask you this. Does anybody else want to comment on Mr. Buffett's comment?

Mr. MAINE. Yes, I do.

Mr. Chairman, FASB is calling for this to be treated as a current-period operating expense. According to FASB's own statement of concepts, number six, they define an "expense" as an outflow, or other using up of assets, or incurrence of liabilities from delivery or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

That is how FASB defines an expense. In my mind, this does not fit FASB's own definition.

Senator DODD. Any other comment on this?

Yes, Lisa.

Ms. CONTE. Yes. First of all, I would hate to debate Mr. Buffett on financial grounds. However, I have a CFO that I pay a small amount of cash to and stock options to who probably could do it.

But if you talk about the impact on the overall value of the company, when I issue a stock option there is no impact on the value of my company; you cannot see it in terms of the dilution on the earnings per share.

However, if the FASB proposal goes through, there will be a perceived impact on the value of the company, and that will not be truly representative of the company's value.

Also, I would comment that Warren Buffett is the person who is going to be the least impacted by a FASB proposal. It is the low-level employees of companies like Shaman Pharmaceuticals—the dishwashers and technicians working in the lab—who are going to have their lives most impacted.

Senator DODD. Let me pick up on that point.

One of the arguments has been how that options are tremendously helpful in attracting people that you cannot otherwise get.

It strikes me that, if we had a rule here that applied to everybody on the same grounds, that that argument loses its weight. Because if everyone in the country has to compete on the same basis of hiring those people, then of course you are not disadvantaged by the common denominator universality of the rule. How would you respond to that question?

Yes?

Mr. GILBERTSON. Well, I think there are different types of companies. There is the large company in which the ongoing entity is assured, therefore your income is ensured for a period of time. But the upside potential is minimized because it is such a large organization that it is not going to dramatically increase its wealth or value overnight.

That particular company, no matter how you value the options—and maybe you can even predict better the value of the option—is a company which could be put on a more level playing field.

The reason people go into the smaller companies and take a reduced set of benefits or reduced compensation is the big-win upside risk, but it is a risk.

When I chaired the American Electronics Association, 10 percent of our companies went out of business every year. The bottom line is that probably only 1 out of, I don't know what the right number is, 1 out of 6, 1 out of 8 options ever comes into the money—or actually probably even worse than that, 1 out of every 6 companies ever becomes public, one out of every X times 6 options ever becomes worth anything—So what they have done is to take a very significant risk, and maybe a reduced salary, for a very significant win.

So no matter how you change the accounting rules, the person who makes the decision to go into that small private company is not in any way, shape, or form using the option for the same purposes, or at least valuing the option as the same incentive as the person who is in a large company which is a much more steady producer and whose option appreciation is maybe calculable in that it adds 10 percent to his income.

The startup company person is going to try to double or triple his income in one gulp so he can pay for the new house, or the children, and take the risk that he may get nothing out of it—in fact, it is a very high risk that he will get nothing out of it.

That is the problem with the accounting for it. Most of the accounting that will be put on these financial statements will be a lump sum which you will be depreciating over time, but for all intents and purposes you have increased your assets and your equity, but it will never happen. So it is just false accounting. It is conceptually incorrect to ever put it on your balance sheet, or expense it.

Senator DODD. Let me ask you, Mr. Leisenring. You said there is just no further debate or discussion as far as the question of whether or not this ought to be expensed. Well, how about the suggestion that this is a capital transaction? A lot of what motivates this is of course the headlines and the stories of the CEO who has exercised an option and made a lot of money. In many cases it is not even fair to them because they have been involved in the growth of a company over years, and all we know about is the day when they get to exercise the option. What they have done to con-

tribute to the growth oftentimes gets lost in paragraph 30 or 40 in the story—but putting that aside, I can certainly understand the kind of reaction you get from the public when they hear about some one person who gets what seems to be an inordinate windfall, far in excess by the way of what our major competitors seem to award their chief executive officers in other nations around the world.

But I have got a feeling that, even if we adopted what you are suggesting here, that there is already somebody sitting somewhere with a green visor on in some corporate headquarters who is figuring out how to award executive compensation that will get right around what you want to do with these rules; that there will be some other form to compensate the executive that will avoid this particular issue. Do you disagree with that?

Mr. LEISENRING. Well, I am not quite that cynical, perhaps about their abilities—nor am I confident in their ability to do that.

If you look at the chart that Senator Levin showed this morning, this is indeed the exception. You suggested that it is a capital transaction, and indeed it is an equity transaction, which is why we measure it as we do, fair value at the date of grant—incidentally, a methodology that Mr. Buffett does support. Measuring it at the date of grant is unlike the measurement that is in the newspapers that included changes in stock prices subsequent to the grant and a decidedly different measurement than we have proposed.

I do not know of any other, in fact I know that there is no other transaction involving an equity instrument that is accounted for in the same way as employee stock options. All other equity transactions are accounted for.

Senator DODD. Well, Mr. Bunt suggested—I think it was Mr. Bunt, or you, Mr. Brown, suggested something other than just this that was treated differently.

Mr. LEISENRING. I did not understand his comment.

As we have submitted, and I have not seen any evidence to the contrary, I believe that all equity exchanges are accounted for. This one is accounted for as compensation expense because it is a bargained exchange between an employer and an employee. It is indeed an exchange for service and is earned over a service period, which is why you have the amortization pattern that the gentleman on my right referred to.

I don't think that you can avoid and produce the zero answer that you suggest under a great many other accounting rules other than the one we are proposing.

The method we are proposing is a way to level the playing field. I have found it ironic that this morning's conversation talked about performance options, and indeed performance options are almost never granted.

They are not granted because the accounting results in exercise date accounting, potentially, with a very, very large compensation charge for an option that is demonstrably less valuable than the plain vanilla non-performance or contingent option.

All we are trying to do is to level the playing field in a way so that compensation systems can be devised with the type of package

that managements believe is motivational and do it in an even-handed way, rather than being led in a direction by the accounting.

I do not accept that options will all go away. It seems to me that corporate management, like the individuals sitting with me at this table, would behave rationally and assess the costs of recording the options.

They would also then try and assess the benefits. We would concur with them that the benefits are probably quite significant. I have no empirical evidence of how significant, but I would just stipulate and agree with them that they are beneficial. I also agree with your premise that ownership is desirable.

It seems to me that what will be curtailed is those options where people believe the costs exceed the benefits. I think they will continue to be issued, but they will be restructured as to their form, perhaps, to be more performance oriented than they are today. But I do not accept that they will all just automatically sort of melt away and dry up.

We have heard about from the debate today is essentially that certain people will be harmed. I am not sure that "harmed" is the right word, but I know that if you make a cost/benefit assessment and believe options still should be granted to your employees and you do that, and the market penalizes you in some way—whether it is an incremental cost of capital or something else what would you have relevant accounting information do but produce that result?

It seems to me that accounting would be doing exactly what it is supposed to do, helping the capital allocation process by the marketplace, not by us, and not by you with the public policy conclusion that you want to promote options in some fashion. We think the market ought to decide the value of that.

Senator DODD. Before I turn to Mr. Gilbertson, let me ask you one more question. I appreciate you saying that, but you have invited public comment on the proposal. Yet, I don't hear much flexibility here.

Mr. LEISENRING. It is not over—there is more than is implied. It is a subtlety, and I am sorry about that. I am not trying to be disingenuous, really I am not.

As I said in the testimony, there has never really been any debate, I do not think, in accounting whether stock options are compensatory, predecessory have concluded that.

But there was debate, as Ms. Barth pointed out, as to the ability to measure. The technologies have changed dramatically. The range of measurement goes from anything just above zero up to what we have proposed, or even dramatically more than we have proposed, because we will receive some comment that we should go, as Mr. Bunt said he objected to, exercise-date accounting as an alternative. We do not agree with that. So there is a lot of flexibility within that measurement range, and indeed that is what we wish the debate would be about.

Mr. GILBERTSON. Let me just take exception to two points, and use an example, with apologies to the National Venture Capital Association alongside of me.

If one assumes that there are certain companies that at some times are desperate for capital and therefore take on an investor

at a steep discount to the net worth of the company, than using your argument to its logical extreme, one should say accountants should somehow immediately expense this discount on that venture capital put into the company in a capital transaction and call it a compensation expense even though you are not compensating the venture capitalist.

In reality, a stock option is a capital commitment on the part of that employee. That employee is going to give you money—real, live dollars—to exercise the option, at which point he probably will not sell the shares. There is a high probability he will hold the shares.

He is not yielding himself any cash gain whatsoever. There is no cash compensation loss to the company. And in the example I gave, it is virtually the same example. It just happened to be a venture capital investment.

My second exception relates to your point on the performance stock options—in other words, non-qualified versus ISO's—is that there are two different tax treatments.

Mr. LEISENRING. No.

Mr. GILBERTSON. That is not your point?

Mr. LEISENRING. No, sir.

Senator DODD. So what was the point?

Mr. LEISENRING. The point is that under the accounting rules now a fixed option is one that fixes both the price and the share amount at the date of grant.

As long as the intrinsic value is zero—in other words, the option is not in the money when granted—no matter what happens ever, you will always get zero as the compensation result throughout the life of that option.

If there is any performance contingency—in other words, you say I will grant you 10,000 options at $10 a share, which is the fair market price, but only if we achieve certain objectives for earnings growth, whatever that might be—any contingency of that sort under the existing rule becomes a variable plan and is accounted for as expense at the date it is exercised. It is a fundamentally different accounting notion.

No one wants to take the risk of having their share price go up four or five-fold and have an enormous compensation charge for the performance plan.

I used the term as our document does—performance plans are those with certain contingencies that must be met as opposed to the fixed plans which are fixed price, fixed number of shares at date of grant.

I do want to make a correcting comment, however, on one point.

You are absolutely right that you could have a transaction where an investor on behalf of the corporation did something such as an interest-free loan, or whatever else they might do. Current accounting requires that to be accounted for as an expense.

Mr. GILBERTSON. No. This was an investor on behalf of the corporation. This was an outside investor.

Mr. LEISENRING. I'm sorry.

Senator DODD. Let me ask you this before I get to Mr. Morgan. I think you just answered this, but he raises the point obviously

in venture capital. I will quote him here in his statement—I think this is from your prepared statement. You are talking about:

Few employees of emerging growth companies would agree with FASB that their stock options are 'probable future economic benefits.'

It goes on further to say:

These options are non-transferable, fortifiable, and of zero immediate value, as they are typically granted at market and can't be spent.

I guess that was what your last comment was, Mr. Leisenring, on that particular issue. How do you assign a fair value to options that exist in these types if circumstances?

Mr. LEISENRING. In circumstances where they are at the market, that is what the option pricing models attempt to do to estimate the value of the option.

Remember, we are not attempting to predict future values—the comments that a Black-Scholes pricing model fails to predict future stock prices are the sort of thing that we ought to laugh about. Certainly a $49.95 piece of software cannot accurately predict future stock prices. If you could do that, we would all probably retire because we would be very successful at predicting future stock prices.

Option pricing models do not attempt to do that. They attempt to value the right to participate in the future changes in stock prices. That is a much different notion, and I believe that our document tries to point that out—perhaps not persuasively or effectively—but it tries to make that point.

And there are uncertainties. I cannot, and would not intend to deny that. We have said over and over again, that we are more than willing to debate measurement alternatives.

A couple of the points Mr. Bunt made are the result of our trying to accommodate the unique aspects of employee stock option plans. They bring about some things that, in some respects, are less than desirable, or counter-intuitive to some people, but they are an attempt to accommodate an estimation technique that is widely used for lots of other transactions.

I think we should not forget what Ms. Barth said in her testimony. This is not a novelty. It is perhaps a novelty to apply it to employee stock options, which have two unique aspects that we are trying to accommodate. The fact that they are forfeitable, they may not vest, the fact that they are not transferable.

Those are the only unique features we are attempting to accommodate in the technique. But the technique of option pricing models is otherwise applied across a dramatic array of financial instruments involving I suspect trillions of dollars of transactions annually. And those transactions are, incidentally, audited by accounting firms and are now in financial statements. This is not a unique application of some black-box type of magic accounting as is being implied by some of the comments.

Mr. BUNT. Let me respond, first of all on the point of being able to estimate things.

The point is there are things in the financial statements that if you cannot estimate it, all you do is disclose it. That comes under FASB V, certain contingencies. And so the idea——

Senator DODD. You agree with that?

Mr. BUNT. The idea of a contingent zero estimate if you have no better estimate and no way of knowing the number that is legit.

Second, where we are at right now it is simple. If a share of stock is selling for $100 and I allow you an option at $50 to buy the stock for $50, you are $50 in the money and my expense is $50. If I give you the option at $75, you are in the money by $25. The expense to the company is $25. If I give you the option at $100, now we are into some esoteric things that say, hey, wait a minute, the $50 you got was really $60, the $25 you got was really $35. The $100 you get, even though it is zero, not in the money, has some sort of esoteric value that the market can tell you about. But those happen to be traded options and if they issue a 10-year option, it will trade and trade and trade for 10 years without the kinds of restrictions or anything else that are associated with it.

If I get option for $100 on day one and on day two I leave General Electric and lose the option, I cannot sell it to anybody for any value whatsoever. These are not traded pieces of paper. So we are making adaptations to traded models and this is where some of the anomalies come in.

United States Surgical stock had options at $6. The option pricing model would say, well, maybe the option is worth a buck. United States Surgical shoots up in value to $50 because the company is very successful, the employees say, hey, this is great, we're going to cash in. United States Surgical says, geez, you know, we did a calculation and said the option was worth a buck according to this option program but our stock shot up in 2 years. The average life of our option is a lot less, so we should have charged only 50 cents, so we made more income even though our employees also did.

IBM, they book a $159 option in 1987 and watch the stock go in the tank. In 1993, they look back and they say, gee, nobody exercised any options. We assumed a 5-year period. So, what's their problem? Well, what they have to do is say, those options were worth more because the average life wasn't 5 years. The average life is now 7 years, maybe even 10 years if the stock ever gets up to $159.

So you report to the share owners that they just lost more money on a pencil transaction because we mis-estimated the stock—the life of the stock in 1987.

And these are the kinds of—you know, they really get into—I used the term angels on the head of a pin. We know that some will fit. How many? I don't know. And if you don't know and can't get to the answer—and this is not tested, not tested at all. There is a field test that is being planned.

Almost every company issues 5- to 10-year options at least. Five, 7, 10 years. What's the field test? Go back and look at your data for the last 3 years. It is totally superficial. I mean, it is not a legitimate field test.

General Electric, unfortunately—we have participated in every single FASB field test. This field test, we wrote them a letter and said, unfortunately we cannot participate because the test that you are proposing will not get at the crux of the matter as to how reliable what you are proposing is. That is really the crux of the argument.

And 20 years ago, the AICPA came out and said, all right, if it's $100 stock and I give it to you for $50, it's a $50 expense. If it's

a $100 stock and I give you an option of $100, it's zero; we can't come up with a better number. It's the intrinsic value.

These people now have started to say, well, we can adapt trading models to things that don't trade. Jim Bunt gets divorced 4 years ago, he's got to settle up. I don't act as a rational share owner. I am in Connecticut. It goes 50/50—you may know that. And I had to cash.

Senator DODD. How did you know that I would know that? [Laughter.]

Mr. LEISENRING. Well, you're from Connecticut.

Senator DODD. 50/50 wasn't a big deal, 50/50 of nothing.

Mr. BUNT. We are not traders.

The other thing about it is the volatility of the stock. Let's listen to how the model works. If I asked you to come and join General Electric and here's $50,000 base salary and an amount of options, OK, because the volatility of GE stock is less than some other companies, the option value is lower for our stock.

Now if somebody asks you to go to work for CGT Technology or some company that's been in and out of bankruptcy for five times in the last 6 years and you're thinking about supporting your family and everything. They're going to give you $50,000 and some options.

Whose options do you think are worth more, GE's, which is going to follow the market, or the other options the guy is giving you where, hey, it's up, it's down, it's restricted, they may go bankrupt and everything else?

The option pricing model says that, hey, CGT options are worth a lot more than GE options. Why? Because it's volatility. Traders love volatility. You know, if a stock goes up and doubles, people buy it. Then it falls by 50 percent, then they can tout it again. They love volatility in these things and they can play it on the computer screens.

We can't play things on computer screens. And not with this. So that the fundamental flaw here is that we are looking at a formula that, yes, some high-paid good theoretical mathematicians, Myron Scholes and Fisher Black came up with and they've been modified and adapted and they run them on Sun computers.

But to ask me to throw in the assumptions, to ask the SEC to audit and validate or Peat Marwick to audit and validate the assumptions and are they any good for how I came up with my numbers versus some other company's numbers, versus anybody else's, oh, you should have used this assumption, you should have used some others. It doesn't give a credible answer. That's where they were in 1972 and somebody is now looking at a computer on a Sun workstation saying, oh, now I've got a way. It's a different instrument. It's a different animal, entirely.

Senator DODD. Do you want to comment?

Mr. BROWN. Mr. Chairman, may I comment on that?

Senator DODD. Let me give Mr. Leisenring a chance.

Mr. LEISENRING. I think that I have said two or three times that the debate is over measurement. Mr. Bunt and I will disagree on some aspects of that measurement, but there are also alternatives. You don't necessarily in accounting use zero but an item that is hard to measure.

Most of his argument would suggest to me that he is advocating measuring it at the exercise date, because then——

Mr. BUNT. Absolutely not, Jim. I—after grant date, it is a share owner. It is outside, it is external to the financial statements of the company. You know that, you agreed with that, and that's exactly what I said here today.

Mr. LEISENRING. I——

Mr. BUNT. It is external to the financial statements after grant date. We're only talking grant date.

Mr. LEISENRING. That is well and good. There are several other circumstances, however, where we choose to measure things, including the contingencies that he referred to, at the settlement date because they are circumstances that we just can't measure at a certain point in time, so you delay the measurement. You don't necessarily say, don't measure it at all.

We believe, as he does, that it's not really the right measurement for this particular exchange transaction. But we also then would disagree as to the technology, at least we have tentatively done so in the exposure draft. We hope that you can in a suitably reliable way as Ms. Barth said in her testimony, measure the grant date.

I absolutely reject his criticism of our field test. It is unfortunate that GE has chosen not to participate. But I don't believe that it is appropriate to criticize the credibility of it.

Senator DODD. We could go on here all afternoon in a sense, and I think the points have been made, pretty strongly.

I am deeply grateful to all of you for taking time to come down and sharing your thoughts with us. And obviously this will be the subject of some considerable discussion and debate among ourselves here. Obviously, we would like to stay in touch with you as questions come up and be able to submit some additional thoughts to you for your comment.

Mr. Leisenring, we appreciate immensely your presence here today——

Mr. LEISENRING. Thank you. It's been a pleasure.

Senator DODD. —in responding to these concerns. You handled yourself very well.

Mr. LEISENRING. Thank you. I appreciate that.

Senator DODD. In terms of taking the other side of the question here before us.

We'll be back to you.

Again, my apologies for not being here at the outset this morning. My thanks again to Senator Boxer for her generosity in chairing the hearing.

This is a very important question for us up here. We take it very seriously. I don't see us acting precipitously, but I think there clearly could be a congressional response. But that will be the case. So with that in mind, we will keep you posted. And thank you again for your presence here today.

The committee will stand adjourned.

[Whereupon, at 2:00 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

## TESTIMONY OF REPRESENTATIVE ANNA G. ESHOO

### U.S. Representative of Congress from the State of California

I thank the distinguished Chairman from Connecticut for holding this hearing on stock option accounting and for allowing me to provide testimony on this critical issue.

I would like to associate myself with the remarks of my friend and colleague, Senator Bill Bradley. This is certainly a complex issue and the range of Congressional response to the Financial Accounting Standards Board's (FASB) recent proposal does nothing to simplify it.

Supporters of the FASB proposal argue that it will put an end to highly publicized "fat-cat" executive salaries. This is certainly a worthy goal, and I want to stress that I strongly support improved financial reporting and disclosure of employee compensation.

However, this proposal will primarily affect thousands of average working Americans, not easy-to-target top executives. Furthermore, by discouraging the use of stock options, this proposal will adversely affect the ability of entrepreneurs and start-up companies from prospering or even getting off the ground. FASB's proposal will have the most devastating impact on the country's most competitive industry, high-technology.

I represent Silicon Valley, where some of this country's largest and most competitive companies, such as Hewlett-Packard, Apple, Sun Microsystems, and Advanced Micro Devices literally grew out of a dream. Many of the innovators in my district started with an idea and maybe a garage out of which to work. Without stock options—the ability to give their employees a piece of the dream—most would not have survived. For these and other high-tech companies, the FASB proposal simply does not compute.

The astounding vitality of the high-tech industry is attributable in part to the continued use of stock options which encourage employees' ongoing commitment to a company's success. Given this, I do not understand how today, in the face of increasing competition overseas, we can even consider devaluing this important tool. Yet by requiring companies to charge against their earnings the value of stock options, the benefits of using stock options are effectively negated. Indeed, a recent survey indicated that high-tech companies would suffer close to a 50 percent reduction in profits if they would continue to use stock options under the new accounting rule. No incentive is worth that much to any company, particularly start-up firms which need investment capital.

Although I feel very strongly about this issue, I feel just as strongly that Congress should not interfere with FASB's lengthy standard setting process. By introducing our non-binding resolution, Senator Bradley and I join with Treasury Secretary Bentsen, members of the SEC, and over forty of our colleagues in stating our concern about the economic implications of the FASB proposal. Legislating stock option accounting at this point—whether for or against the FASB proposal—would be inappropriate. I only hope that FASB listens carefully to all of our concerns as it considers its proposal.

In closing, I would like to reiterate that I understand and agree with concerns about executive compensation. These concerns can best be addressed through greater financial disclosure and reporting, such as the recent SEC rule which increases disclosure obligations of public companies.

I also appreciate FASB's desire to treat stock options like other forms of compensation. But stock options are not like other forms of compensation and should not be treated as such. To do so would result in adverse and far-reaching economic consequences.

Mr. Chairman, once again I would like to thank you for holding this hearing today. I look forward to working with you in the future on this critical issue.

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## TESTIMONY OF SARAH A. B. TESLIK

### Executive Director, Council of Institutional Investors

First, I want to apologize. We, America's shareholders, are responsible for the original problem here: we are the ones who used to automatically vote for every executive compensation plan teed up to us at every company, including plans that allowed stock options to be abused. Senator Levin was one of the first to point out that excessive option awards harm shareholders and pensioners and employees. For this he deserves a sincere thank you, and I am pleased to extend one.

The real solution to *this* problem is obvious. These plans require shareholder approval. We need to vote against the bad ones. It is that simple.

If, however, we try to solve this problem by forcing companies that use stock options to show transactions in their financial statements that make them look bad and that never occurred that way, we will create a problem much, *much,* larger than that of excessive stock option use.

So a compensation problem has raised an accounting problem—and a big mess. And on that front I also need to apologize. It is almost certainly our fault that this accounting issue seems to be one of the most misunderstood issues of all times. We get calls every day from people who assume that what really is going on here is that FASB has proposed something that we all know in our heart of hearts is the right answer from an accounting point of view, but that we all have personal, financial, or non-accounting policy reasons to oppose.

I am here to tell you that this is certainly not true for us. There is no group that has a greater interest in principled "right" answers to accounting questions than we do. We are the people who invest real money—huge amounts of money—based upon what we read in financial statements. We are America's employees and America's retirees, and we will not get our pensions if we do not invest wisely based on accurate financial information. My average retiree gets a monthly paycheck of $512. And many of my members' future pension checks will bounce unless the pension funds perform very well as the population ages. So *no one* will be hurt more than we if *any* other agenda—however virtuous—is pursued at the expense of the accuracy and usefulness of financial statements. This is real peoples' real grocery money.

I have one final apology. I am not an accountant—I am a civilian—and I can only speak in plain English on this subject. So I will make only a couple brief points.

We agree with Senator Levin and FASB on almost every point. We agree that stock options have value. We believe that that value can, in many cases, be reasonably—although not precisely—estimated. We could agree that these options, when issued to employees, are compensation, and the cost of that compensation is ultimately borne by shareholders. We agree that compensation costs should be shown in the financials. The only question that divides us is, how? How should these costs be recognized?

We also agree with most of the premises FASB relies on to answer this question. We, too, want information we can understand. We want information that lets us accurately compare companies. We want information that doesn't cause inappropriate discrimination between forms of compensation. We want information that is accurate.

We just don't agree that FASB's proposal gives us these things. We believe there are alternative proposals that would. And finally, we believe that these alternatives avoid the significant distortions and inaccuracies that the exposure draft creates.

Here, in a nutshell, are our problems with FASB's proposal.

The exposure draft requires companies to put something in their financials *that isn't true.* I realize polite people don't talk like this, or shouldn't, especially at Senate hearings, but I don't know any other way to make this point accurately. Investors who read financial statements, when they see a charge to earnings, understand it to reflect an item of the kind that will, at some point, require the payment of cash, the incurrence of a liability, or the dissipation of an asset and that could, if taken to extreme, bankrupt a company. A payment of cash can do this. A pure equity transaction cannot. But the exposure draft requires companies to pretend that these capital transactions are cash transactions and show them as such on the income statement.

Certainly one could picture reasons why one might want to require such pretending. For example, one might want this if these equity-based transactions *didn't show up anywhere else* in the financials, and this was the only way to tell investors that compensation-related events had occurred about which they should care. But this is not the case: current financials *have* places where capital transactions are disclosed—and disclosed in the way they actually occur—as capital transactions that cost shareholders by diluting their earnings.

One could also picture this kind of pretending if it provided more accurate or more useful information to investors. But, in fact, it does the opposite.

FASB emphasizes that one of the key reasons why it wants to account for stock options as if they were cash transactions is that options would then be treated like other equity-based compensation, creating consistency. FASB notes it is difficult to compare one kind of compensation to another, or one company's compensation to another's, without consistency. We agree.

But, FASB's exposure draft *itself creates major* inconsistencies. The second is that this proposal does not eliminate—and doesn't *try* to eliminate—inconsistent treatment of equity-related events: we all know, for example, that when stock is issued

*into the market* instead of for compensation, FASB does not require—or even suggest—that a charge is necessary for consistency. And yet in both cases equity is issued—the only difference is *to whom*. Finally, if the treatment of other equity-based compensation arrangements is currently inaccurate, it makes more sense to correct the inaccuracy rather than complicate the problem by including options, just to be consistent. A foolish consistency is no more appealing to us than it was to Mark Twain.

Consider these inconsistencies. Although, under the exposure draft, companies would be required to place a cash value on options, they can use a wide variety of methodologies and assumptions to generate these values. This effectively destroys *any* meaningful consistency and therefore any meaningful comparability across companies—it is like letting people use different rulers but requiring that they report a single measurement. This phantom accuracy is neither useful nor consistent: it implies an accuracy and a consistency that isn't there.

In addition, although FASB says it wants to treat all options consistently, the exposure draft actually continues to require inconsistent treatment of different types of option plans. For example those that cannot be valued at grant date are required to be valued at date of exercise. The result is that the accounting for these options will be materially different than the accounting for other types of options. And the accounting differs markedly for stock-based compensation that can be settled in cash and stock-based compensation that is settled only in stock. So do not start thinking the exposure draft creates consistency.

More importantly, we shareholders want to know how much we pay our employees, and in what form. If there is *any type* of information you could *assume* would be useful to us, it would be this. What are we paying these people? The exposure draft makes this *impossible*—it does *not* require companies to *tell us* the new number FASB tells them to generate with the formula of their choice. Companies are allowed to roll this number into other numbers on the income statement. This means we may no longer even be able to know precisely how much employees are receiving *in cash,* because the real numbers and the soft numbers may be combined. This makes this proposal almost useless to us.

I have sounded very negative, and I am sorry for that. I do think that too often problems that should be handled by private parties become your problems because the parties have acted irresponsibly. We have tried to work with everyone. We did submit an alternative to FASB. It received widespread support.

In our proposal we agreed that the current system does not give us all the information we need. Options *are* potentially dangerous compensation tools: because they do *not* require a company cash outlay and because, when they do affect shareholders, they often do so years after the grant date, there is a big danger they will be used excessively. We therefore asked FASB for a better early warning—a better heads up—to be supplied when options are granted to give us the best possible sense of their impact on us and their value as compensation. We asked that the options be valued, that they be valued using a pre-established methodology, that the assumptions be disclosed, that the valuations be disclosed as separate numbers, and that these and other key facts be highlighted so that our attention would be drawn to them. And we asked that these new disclosures appear in clear note form and that they not be transformed into any new charge to earnings.

After we submitted our proposal, the AFL–CIO supplemented it. Their most significant additional request was that key information appear on the face of the income statement to insure an effective heads up and emphasize the connection between compensatory options and other types of compensation. We are working on another proposal that builds on our first, on the AFL–CIO's additions to it, and on FASB's subsequently released exposure draft.

We recognize that these proposals have new elements. Our country was founded by people who seemed willing to entertain new ideas. We are not experts, but we are willing to think new thoughts and study old ones. We are willing to consider others' ideas. We think it is not helpful to suggest that there are only two alternatives here, or that we have to do something some way because we've done other things that way for years. We have worked with FASB and are willing to work with them—and with you—to try to make sure that our beneficiaries are protected, both as workers and as retirees, and that our markets are kept the best in the world.

Thank you.

## TESTIMONY OF LISA A. CONTE

### President and Chief Executive Officer, Shaman Pharmaceuticals, Inc.

I am Lisa Conte, Chairman and CEO of Shaman Pharmaceuticals, Inc., a four year old, 90 person biotechnology company that is discovering and developing pharmaceuticals from rain forest plants with a history of medicinal use. I am appearing before the Subcommittee today as a representative of the Biotechnology Industry Organization (BIO), on whose Board of Directors I sit. BIO is the national trade association for the biotechnology industry, and has taken a strong stand in opposition to the Financial Accounting Standards Board's (FASB) recent proposal to require that companies charge earnings when they issue stock options.

Because of the importance of stock options to the biotech industry, and the threat posed by the FASB activities, BIO has endorsed the Equity Expansion Act (S. 1175) introduced in the Senate by Joe Lieberman. S. 1175 offers companies like mine an opportunity to use a new form of performance-based stock option; it also prohibits the implementation of the FASB proposal. BIO has in addition endorsed S. Con. Res. 34, introduced by Senator Bill Bradley, which expresses this body's concerns about the job-loss and competitiveness consequences of the FASB regulations.

I am here to convey BIO's message about the FASB stock option proposal, which we believe to be misdirected, unnecessary, and harmful to the long-term growth potential of our industry. However, before I do so, I would like to describe my own company's experience with stock options, which I think are typical of the biotechnology industry as a whole.

I founded Shaman Pharmaceuticals a little less than four years ago with advances from my personal credit cards. The company has grown in that time from one employee—me—to our present size of more than 90, over 70% of which is either female or minority. I was able to hire over half of those 90 people just this past year, as a result of Shaman's successful initial public offering in January.

That IPO brought over $41 million into the company. It not only allowed me to hire new employees at a time when many, many California companies are being forced to initiate layoffs or close their doors, but has also made it possible for Shaman to add critical talent to our research and development and management teams. As a result, we have been able to advance two of our products through the initial research stage into human clinical testing.

One of these products, currently before the Food and Drug Administration, is a new treatment for RSV (respiratory syncytial virus), a common respiratory illness which strikes all children at least twice before the age of five. RSV is one of the major killers of children in developing countries, and the only current treatment is one which must be administered in a pediatric intensive care unit. Our product is in an easily administered liquid form, and is derived from a plant which grows naturally in South and Latin America and has been used medicinally for centuries. The second product is derived from the same plant, and will be used topically for the treatment of herpes lesions. It is intended for use in AIDS patients that do not respond to the only currently approved herpes treatment, known as aciclovir. Shaman has a rich pipeline of other plant-derived compounds on which we plan to undertake human clinical studies as resources become available to us. One of them about which I am particularly excited is an anti-fungal product for the treatment of thrush, a common fungal infection that affects the gastro-intestinal system of immune-compromised patients such as those suffering from AIDS or who have had organ transplants or chemotherapy.

As I mentioned, my company's experience with stock options is typical of the biotechnology industry as a whole. Since Shaman's founding, every one of our employees has been granted options as part of his or her benefit package; Shaman employees are also awarded additional options based on performance. For an emerging growth company like mine, stock options are perhaps the single most important means of attracting talented people to participate in the high-risk, high-reward world of biotechnology. Because I was able to include stock options, I found that I could offer potential employees attractive compensation packages but at the same time limit the immediate financial exposure of the company—which, given the lengthy product development times and enormous capital needs of our industry, was a significant concern for the brand-new 29 year old entrepreneur I was when I founded Shaman.

Stock options have provided Shaman employees with a tangible sense of ownership in the company, and an important added motivation to see our company succeed. On a more concrete and practical level, stock options have given Shaman employees one of their best opportunities for home ownership in the high-priced Bay area housing market. I hope that Shaman stock options will add up to a comfortable retirement for our employees. I also like to hope that stock options will help our

employees to provide their children with the education that will allow them to become the scientists and CEOs of the Shamans of tomorrow.

If the FASB proposal is adopted and Shaman forced to treat dollars earned through stock options as a salary expense, I think I would be unlikely to cut back on the broad use of stock options in my company. However, the proposal, if implemented, will have the effect of reducing our earnings, and as a result, negatively impacting Shaman's attractiveness as an investment. I want to highlight for this Subcommittee the fact that Shaman, like many biotech companies, does not presently have any earnings. Even after we are able to bring products to the market, this proposal will delay considerably the time period before which we will show a profit. This will not encourage the investor community to look favorably on my company, or others in the industry.

This impact is particularly pernicious for the biotechnology industry. Biotechnology companies, and especially newer, smaller companies like mine, are already dealing with a number of external factors which have made the markets and the investment climate considerably more difficult. The public debate of price controls in health care reform, for example, has taken a toll on investment in our industry. Coming in addition to these issues, the implementation of the FASB proposal could have a further depressant effect on the financial markets for biotech companies, persuade some CEOs to cut back on the broad-based use of options in their companies, and eliminate one of the most effective means available to the biotechnology industry to attract talented personnel.

The Biotechnology Industry Organization believes that the FASB proposal is misdirected, unnecessary, and harmful to the long-term growth potential of the biotechnology industry. The FASB proposal seeks to level the playing field between companies which offer stock options and those that do not in order to ensure that shareholders and others are fully and accurately informed about corporate financial obligations. In the United States Congress, legislation has been introduced to encourage the rapid implementation of the FASB proposal in order to prevent abuses in executive compensation.

BIO shares the concerns about full and accurate disclosure, and about the prevention of abusing options to employees' and shareholders' detriment. BIO supported the SEC's efforts last year to develop and implement regulations which would improve the disclosure of stock options; BIO presently supports efforts to substitute a fuller disclosure option for the present FASB proposal.

But BIO companies feel strongly that the FASB proposal is misdirected. The proposal is an effort to provide a level playing field. But it goes much farther than that by mandating an onerous expense to be recorded each time a new option is granted—in spite of overwhelming opposition by investors and users of financial statements. Instead of discouraging "corporate fat cats," its most direct impact will be felt in high-tech, emerging growth industries like ours, which must rely on stock options to attract and retain talented personnel.

The average annual compensation for a CEO in a biotechnology company is $222,000. Biotechnology companies have enormous capital needs—over $300 billion to develop a product, from discovery to market, and average monthly burn rates of over $750,000. Because of the need for stringent FDA review of our products at virtually every step of the development, testing and manufacturing processes, biotech companies have product development time lines of ten to 12 years. Very few companies in the industry are profitable, and overall the industry lost a total of $7 billion in the last two years alone.

But in spite of these financial and product development circumstances, biotechnology companies have undertaken some of the most creative, innovative and high-risk biomedical, agricultural and environmental research ever attempted in this or any other country. We need to attract world class scientists and researchers to our laboratories, perceptive and far-sighted managers to our corporate offices, and an enthusiastic and dedicated corps of employees to support our scientific efforts. These are the people, we believe, who will discover treatments for AIDS, Alzheimer's disease and cancer; these people will develop pest- and drought-resistant crops to feed starving people all over the world; they will find new agents to clean up our environment.

These kinds of people are not easy to find. And when biotechnology companies find them, they must compete for them with larger, richer and more established companies which can easily offer financial incentives well beyond the reach of our companies. Our companies use stock options to attract talented and creative people. BIO feels that stock options offer our member companies the opportunity to share the rewards of success with those who have risked much to make it happen. Stock option exercise also provides small but significant cash infusions for many companies.

Biotechnology companies use stock options broadly. A 1992 survey of our association's membership showed that over 70% of our companies use stock option and other long-term incentive plans, and that more than 50% offer those plans to 100% of their employees. These results are consistent with other surveys of smaller and high-technology companies generally.

BIO fears, however, that the recent FASB actions will reduce our companies abilities to issue stock options. The present financial picture of the U.S. biotechnology industry is bleak: our stocks have lost 40% of their value since January, and almost 60% of our companies have sufficient cash on hand to continue to operate for less than 24 months. Charging earnings for options issued will be yet another blow to an industry that is already reeling. It will make it difficult, or in some cases impossible, for many of our member companies to continue to offer options, especially to all employees. It is ironic that the result of the FASB proposal, which is aimed at eliminating abuses at the highest corporate levels, may well in our industry result in new restrictions on broad-based option plans that will increase options at the higher levels and decrease them among lower level employees. BIO does not believe that this is a policy result that this Congress would like to encourage.

Limiting our ability to offer options limits the ability of our companies to grow, and reduces our potential to contribute to national economic growth. This Administration has spoken out strongly and eloquently about the need to provide Americans with high-skill, high-wage "jobs of the future." Those are the jobs we are offering the biotech industry: some of our most established companies have average annual salaries of approximately $35,000 per employee, and the biotechnology industry has created nearly 100,000 jobs in this country in the last year, up from almost 80,000 last year. While there are significant clusters of biotechnology companies in the Pacific northwest, the mid-Atlantic region, and in Texas, this job-producing potential is concentrated in two of this country's most recession-battered states, California and Massachusetts. But the FASB proposal, if implemented, will have a depressant effect on our ability to create jobs. Again, BIO does not believe that this is a policy result that this Congress wants to encourage.

The FASB threat to biotech entrepreneurship is unnecessary. Present SEC rules already mandate detailed disclosure of options. All of the six major accounting firms and representatives of the investor community have indicated to FASB that the present accounting standards are adequate, and that additional disclosure is an appropriate alternative. Treasury Secretary Bentsen, in an April 2nd letter to the Chairman of the FASB, urged "careful consideration" of a disclosure option. BIO supports a disclosure option, and will be filing substantive comments on the FASB proposal with that organization.

For these reasons, BIO believes that the FASB proposal is unwise policy. We support efforts by Senator Joe Lieberman to prevent the implementation of this proposal through his Equity Expansion Act (S. 1175), and efforts by Senator Bill Bradley to put the Senate on record in opposition to the FASB proposal, through S. Con. Res. 34. We commend Chairman Dodd for holding these hearings to ensure that the debate in the Congress is held on a reasoned and informed level, and are pleased to be able to participate in this important discussion.

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## TESTIMONY OF DOUGLAS L. MAINE

Senior Vice President and CFO, MCI Communications Corporation

on behalf of

The Coalition for American Equity Expansion

Mr. Chairman, and Members of this distinguished committee, I am Douglas L. Maine, Senior Vice President and Chief Financial Officer of MCI Communications Corporation, which is headquartered in Washington, D.C.

*About MCI*

Today MCI is the Nation's second largest long-distance telecommunications company. We have been in business only 25 years, and in that relatively short period have created approximately 36,000 jobs. Our revenues are $12 billion on a current run rate basis. We have invested over $10 billion in our telecommunications system. We provide business and residential service in all 50 states and the District of Columbia, and carry international telecommunications to 98% of all telephones in the world.

We want you to know that we could not have achieved this growth and success without offering our employees a variety of equity compensation plans from the day

we began business. Without stock compensation plans in our early years, we would not have been able to attract the talented professionals who were instrumental in starting a new company from scratch to challenge the world's largest company, and the country's most deeply entrenched monopoly.

In 1972 we adopted an employee stock purchase plan which is available to all employees who have completed 3 months service. We have 401(k) plans through which employees can acquire MCI stock, and an Employee Stock Ownership Plan. Virtually 100% of our employees are eligible for these plans and an average of approximately 70% of our workforce do participate.

We adopted our first stock option plan in 1969 and have issued shares under that and successor plans through this year. Our option plan is not limited to officers or highly paid executives. In fact, it is not limited to management personnel—our non-management, senior staff personnel also participate. Currently over 4,000 of our employees receive stock options.

In the last few years many large companies have had major downsizing and restructuring. We are fortunate that MCI was not one of them. But if we had been forced to rely on cash compensation only during the recent recession years, it is doubtful we could have avoided layoffs, early retirements and other programs most large companies have employed to manage declining resources. But our employees are shareholders, and our compensation burden is not cash laden. So we have kept our jobs, continued our investment when others stopped capital investment, and added new investment and new jobs right through the recession. We continue to do so today.

*About CAEE*

I am appearing before you this morning on behalf of the Coalition for American Equity Expansion. CAEE is a group of companies and professional organizations dedicated to the expansion of equity compensation programs in American companies. We are proud to have worked with Senators Lieberman, Mack, Boxer and Feinstein in developing S. 1175, the Equity Expansion Act of 1993. Our member companies are listed at the end of this statement as Attachment I.

Mr. Chairman, we especially appreciate your invitation to participate this morning. Had America's technology community been allowed to testify at either of Senator Levin's earlier hearings on stock options, we might have helped dissuade FASB from reviving this ill-starred project. Unfortunately, although a Silicon Valley CEO from our coalition asked to be allowed to testify on the day the Governmental Affairs hearings were first announced, we were denied the opportunity to explain in person how this proposal would hurt our industry.

## Testimony Summary

Mr. Chairman, our testimony today can be easily summarized. Although FASB's proposal is not totally indefensible in theory, it is unnecessary; it is unwanted; and it would be unusually harmful. This proposal would be a potent and poisonous job killer. The real-world costs it will impose greatly outweigh its potential benefits. We believe FASB has lost its perspective on this issue. The Board needs this committee to help it remember its responsibility to balance the benefits of its proposals against their costs. FASB should withdraw its stock option proposal.

Contrary to the assertions we have heard from Senator Levin, America's best technology companies and their venture capital backers learned long ago that the key to success in the world's toughest markets is a dedicated workforce that shares the shareholders' goals for their company. Nothing spawns that commitment better than the opportunity for equity appreciation through broad-based employee stock options and stock purchase plans. FASB's proposal would make both forms of broad-based equity compensation prohibitively expensive.

There is a lot more at stake here than a debate over an arcane accounting provision. As Senator Lieberman said when he introduced his stock option bill, "Equity is America's edge in global competition. It's our secret weapon. Neither the Europeans nor the Japanese have yet learned how to generate the kind of employee creativity and commitment that broad-based employee stock option plans have demonstrated for U.S. companies."

Mr. Chairman, rather than simply opposing FASB today we would greatly prefer to be here explaining the positive benefits of broad-based equity compensation programs and how S. 1175, the Lieberman, Mack, Boxer and Feinstein Equity Expansion Act would improve them. We still hope to have that opportunity at a future date.

## Unnecessary: Where are the Victims?

The goal of corporate financial accounting is to provide the information necessary for informed decisions by investors and management. It is not an end in itself. As you are hearing from the investor groups at today's hearing, the current accounting treatment for employee options already provides the information they need to make informed decisions. As they are telling you, if additional disclosure is needed, our companies will readily provide it.

It's important to notice that after ten years of struggling with this issue, FASB has yet to identify *any* real-life victims of today's generally accepted accounting practice.

*Like Retiree Health Benefits?*

Both FASB and its supporters continue to compare the stock option proposal with the Board's recent requirement to charge earnings for future retiree health care benefits. We believe this is an invalid comparison. Charging current earnings for future retiree health benefits is simply requiring accrual now for a future cash expense. Stock options generate no future cash expense to the company. FASB's own pronouncement, Statement of concepts #6, states "Expenses are outflows or other using up of assets or incurrence of liabilities. . . ." Neither occurs in connection with stock compensation.

But also important, in the retiree benefits situation there was a very clear class of people who could have been at risk of never receiving their benefits if the accrual did not take place. In this case though, after struggling with this issue for ten years, FASB has yet to identify *any* real-life people who are at risk of losing anything under the current accounting regime for stock options.

*Like the S&L Crisis?*

The other comparison we occasionally hear is to the collapse of the thrift industry. We think this analogy is also false and misleading. Are those who offer this comparison really suggesting that investors are being defrauded by the absence of a compensation charge for stock options? Are they really contending that companies that don't charge their earnings for stock options today are using that approach to hide their imminent collapse? We think the very fact that this extreme comparison is being offered speaks volumes about the strength of FASB's case for this change.

## Unwanted: Is This What "Generally Accepted" Means?

It's important to notice that unlike many other standards they have issued, FASB's stock option plan has drawn nearly universal opposition from the Board's constituencies. Treasury Secretary Lloyd Bentsen, all six national accounting firms, three of the four SEC Commissioners, the leadership of the Senate Banking Committee, the business community and national shareholder groups have all expressed profound concerns and urged the Board to drop this proposal. But rather than heed its constituencies, the Board has redoubled its efforts to push this plan. In no sense of the word is this new proposal "generally accepted."

## Unusually Harmful

*A Job Killer*

We believe FASB's stock option proposal would be a potent and poisonous job killer. It would cost this country jobs in at least three ways. First, it would increase the difficulty of assembling the management and technology teams that are essential to starting new high-risk ventures. Significant increases in the financial cost of stock options will reduce the ability of venture capitalist firms to pry key technologists and managers away from secure, high salary jobs in established companies. This proposal will inevitably reduce the number of new companies the American venture capital community can create in the future.

Second, this change will reduce the number of new jobs that can be created within each of the new companies that do get started. Where today employees are attracted with a combination of cash and stock options, FASB's proposal will reduce the availability of options and force companies to rely more on their limited pool of cash and thereby limit the number of jobs they would otherwise create.

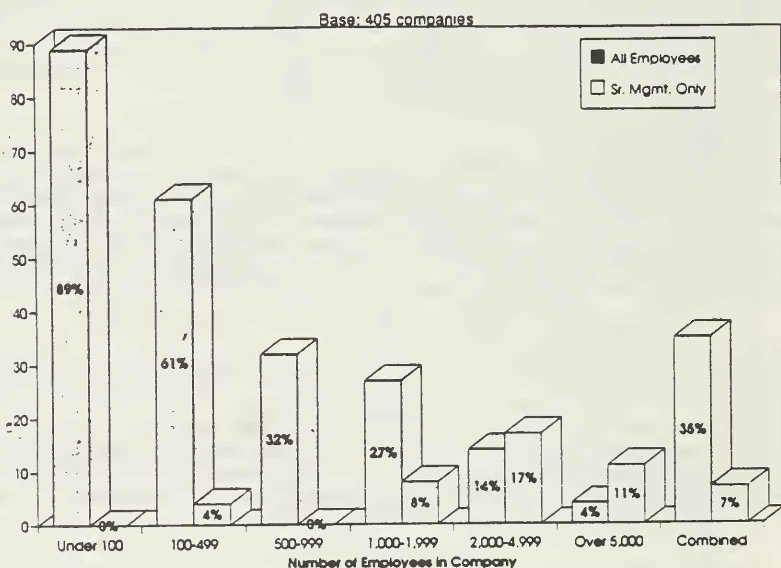
And Third, by reducing the number of employees with an equity stake in the success of their companies, this proposal will damage the profitability and competitiveness of the many U.S. companies and industries that now use stock options and discounted stock purchase plans to motivate and retain their workforces. That will retard their profitability, their growth and their ability to create new jobs.

*ShareData's Study: Company-Wide Options Are Widespread*

Mr. Chairman, much of the political criticism of stock options has come from people who still think of them as a perk reserved for corporate "fat cats." While that may have been true in some industries in the past, exactly the opposite is true today.

Powerful proof of the importance and pervasive use of company-wide option plans comes from a new survey just conducted by ShareData, the producer of a widely-used stock option management software system. ShareData surveyed its 920 company user group to document how broadly they share options within their workforces.

The companies surveyed cover a broad range of industries including banks, chemicals, communications, entertainment, environmental, forest products, health care, retail, transportation, utilities, etc. Only a third of the respondents fall into the electronics or biotech/pharmaceutical categories usually associated with high option usage. And yet a consistent pattern of broad-based employee participation emerges.




Source: ShareData, Inc., 190 Sobrante Way - 100, Sunnyvale, CA 94086

As this chart demonstrates, nine out of ten of the smallest companies share stock options with their entire workforce. Nearly two thirds of the companies with up to 500 employees and 27 percent of the companies with up to 2,000 people share options with their entire workforce. Company-wide stock option plans are very important to America's growth-oriented companies.

*Venture One Study: FASB Would Cause Major Option Cut-Backs*

Rather than improving financial information available to investors, the most important result of FASB's proposed standard would be a significant reduction in the granting of equity compensation in American companies. In an October 1992 survey of 1653 venture-funded companies conducted by the investment research firm Venture One, 88% of the respondents predicted that charging the value of options as a compensation expense would force them to reduce the number of employees receiving such options. 48% said henceforward they would issue options to key executives

only. 10% predicted their use of options would be eliminated altogether. This is exactly the opposite of what we should be encouraging in the American economy.

*An Investor's Nightmare*

Two major concerns about the FASB proposal from an investor's point of view are the new difficulties comparing public and private companies that will be created and the double charge investors will be asked to pay for the same stock option transaction.

First, because some public companies will have to include an estimate of their stock's volatility while other firms will not, there can be major differences in the resulting reportable earnings. That will make it difficult for investors to make valid comparisons between companies. In the Merrill Lynch study described below, differences in reported earnings driven by the presence or absence of a stock volatility factor ranged from 0–38%. These differences will produce unpredictability in earnings trends and surprises for investors.

Second, when FASB argues the present accounting treatment reports "zero cost" for options, they are choosing to overlook the substantial charge to earnings per share that shareholders already incur when they approve broad-based stock option plans. FASB's proposed charge will add an additional charge for the same transaction. In MCI's case our outstanding vested stock options already cost our shareholders $18 million in reduced earnings last year, or a 2.5% reduction in our earnings per share resulting from the dilutive effect of including outstanding options as though they were shares of stock.

But in smaller companies, with broader option plans, the dilutive effect of their outstanding options can be much larger. Xilinx, Inc., a Silicon Valley manufacturer of logic chips with 600 employees, estimates their company-wide stock option plan reduced their investors' earnings per share by 40% the year prior to their public offering and 33.5% the following year. SynOptics Communications, another member of our coalition with 950 employees, reported $1.99 per share last year, but would have been able to report $2.98 if the shares granted for options granted to employees were not counted. Remember these costs have already been incurred, *before* FASB's new charge. This is far from a "zero cost."

*Merrill Lynch Study: A New Burden on Capital Formation*

Even though many companies have already incurred a significant dilution in their earnings per share in order to offer broad-based equity programs to their employees, there is reason to expect that FASB's proposal will add an additional increase to the cost of raising capital for American companies.

At the request of CAEE, Merrill Lynch undertook a study to determine certain data with respect to high-technology equity companies which had gone to market with either an initial (IPO) or secondary (add-on) stock offering within the last 12 months. The study was to determine, based on a fair sample of those companies, had the proposed FASB proposal been in effect—

1. What their earnings reported in connection with the offering would have been, and
2. What their ability to raise capital would have been on that basis, i.e.:
   a. Would they have been able to raise as much capital?
   b. Would the cost of raising capital have been greater?
   c. Would they have been able to go to the market at all?

Based on empirical evidence developed in applying the FASB rule to the subject companies, Merrill Lynch draws three conclusions paraphrased here.

1. Application of the proposed FASB rule would have reduced earnings per share (EPS) between 0% and 41%. It is questionable whether these companies could have raised the same amount of capital on as favorable terms. Their capital raising capacity could have been reduced and the cost of capital could have increased. Had those conditions been bad enough, there is serious question that they could have gone to the market at all.
2. FASB's rule would have a destabilizing effect on subsequent years' trends. Due to permissible differences in valuation data, there could be differences in reported EPS ranging from 0% to 38%. These differences could cause a reluctance on the part of investors to accord a stock the full value it deserves. In other words, the proposal could depress the market price of the stock.
3. Applying valuation techniques which are typically used to value freely tradable options to the valuation of employee options which have different characteristics is questionable and a matter of concern. Companies may be unfairly rewarded or penalized compared with others which use different valuation techniques.

The text of the Merrill Lynch study appears at the end of this statement as Attachment II.

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## Costs vs. Benefits

The Financial Accounting Standards Board's mission statement contains the following explanation of the Board's authority:

> The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function *to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.* (emphasis supplied).

The Board's mission statement goes on to explain the precepts the Board must use in the conduct of its activities. They include:

> To promulgate standards only when the expected benefits exceed the perceived costs.

Mr. Chairman, we question whether the present Board has taken seriously this responsibility to balance costs and benefits. The perfunctory treatment of the question in the Exposure Draft certainly suggests they have not.

To describe the benefit that is supposed to outweigh all the pain this proposal will cause, the Board, on page 16, says simply that recognizing a compensation cost will "improve the representational faithfulness and credibility of financial statements." They also suggest there will be some benefit from ending the difference in treatment between fixed and variable options. In a hundred page Exposure Draft, that's all there is on benefits. Is this a serious or sufficient discussion of one of the central issues in this entire controversy? We don't think so. What we have here is an admission that the Board is pursuing accounting theory as an end in itself, without regard to the costs they are imposing.

## The Role of Theory in American Public Policy

Mr. Chairman, the real issue in this controversy is how to reconcile FASB's academic accounting theory of compensation within our national economic policy. FASB is saying that since they promulgate accounting standards they should be allowed to make this change without any consideration of the larger impact on our Nation's economy.

But we don't usually let academic theory drive public policy in this country beyond the point where the costs outweigh the benefits. Should we in this case?

We don't think you will go wrong if you apply the same rule of reason here that you do in other policy areas. For instance, we don't let economists use the academic definition of income to drive our tax policy into forcing people to pay income tax on the imputed rental value of the homes they own. Even though imputed rental value clearly qualifies as "income" under economic theory, we recognize that the costs of such taxes outweigh the benefits.

In exactly the same way, the costs of imposing FASB's compensation theory on America's economic policy far outweigh the benefits. They need to withdraw this proposal.

## Conclusion

Congress needs to help FASB remember the Board's obligation to balance costs and benefits. We hope this committee will ask the SEC to help FASB rethink and drop its stock option proposal.

Mr. Chairman, we very much appreciate the opportunity you have given us to appear before you today. I will be happy to respond to any questions you may have.

**Attachment 1**

C A E E

**The Coalition for American Equity Expansion**

*1155 15th St. NW, Suite 710, Washington, DC 20005 (202)659-9101 Fax: (202)775-9078*

**CAEE Member Companies**
October 7, 1993

Adaptec, Inc.
Advanced Micro Devices, Inc.
Amgen Inc.
Apple Computer, Inc.
Arthur J. Gallagher & Company
Aspect Telecommunications Corporation
Brooktree Corporation
Cadence Design Systems, Inc.
Calgene, Inc.
Centigram Communications, Inc.
Citizens Utilities Company
Collagen Corporation
Corning Incorporated
Corporate Management Solutions
CUC International, Inc.
IBM Corporation
ICOS Corporation
In Focus Systems, Inc.
InterVoice, Inc.
The Liposome Company, Inc
MCI Communications Corporation
Measurex Corporation
Merrill Lynch
Novell, Inc.
Octel Communications Corporation
Oracle Corporation
The Quaker Oats Company
ShareData, Inc.
SynOptics Communications, Inc.
SyQuest Technology
Tandem Computers, Inc.
3Com Corporation
Xilinx, Inc.

**Technical Steering Committee**

Frederic W. Cook & Co., Inc.
Stradling, Yocca, Carlson & Rauth
U.S. Robotics, Inc.
Wilson, Sonsini, Goodrich & Rosati
The Wyatt Company

**Attachment 2**

**Matthias B. Bowman**
Managing Director

Investment Banking Group

World Financial Center
North Tower
New York, New York 10281-1328
212 449 8200
FAX 212 449 5284

October 19, 1993

Mr. Douglas L. Maine
Executive Vice President and Chief Financial Officer
MCI Communications Corporation
1801 Pennsylvania Avenue, N.W.
Washington, DC 20006

Dear Doug:

We have prepared this letter in response to your request that we comment on the potential effects on the equity capital markets of Financial Accounting Standards Board's Exposure Draft No. 127-C, "Accounting for Stock-based Compensation". We should note that we have previously communicated our views to the FASB with respect to certain accounting aspects of the Exposure Draft and therefore have not readdressed those topics in this letter.

Both the Securities and Exchange Commission (SEC) and the FASB have come under significant pressure from Congress and shareholder interest groups on "executive compensation". In October 1992, the SEC issued revised proxy disclosure requirements for executive compensation. We support the intent of this initiative and agree that full, clear, and understandable disclosure is an important element for shareholder communication and measurement of management's performance.

The use of stock options is widespread and is a means of increasing share ownership among many employees. Furthermore, stock options are used by many emerging growth companies to build capital and attract and retain talented employees during start-up periods. We believe that FASB action to assign a value to stock options and require a charge to earnings could impair the ability of these companies to issue equity to support their growth. This is the basis for our concerns over the likely capital markets effects of Exposure Draft No. 127-C.

In seeking empirical evidence to support our concern in this respect, we asked the accounting firm of Deloitte & Touche to estimate the charge to earnings which would have resulted under the current proposal with regard to what we believe to be a fair sample of technology companies which have recently completed common stock offerings. The results of their calculations and a summary of the assumptions used to

complete these calculations is attached hereto. The analysis attempts to determine what the reported earnings per share of the selected companies would have been at the time these companies were undertaking their common stock offerings, if Exposure Draft No. 127-C had been in effect. Although the sample group is small and certain assumptions had to be made, the results bring three significant issues to our attention.

First, as shown in Exhibit 1, application of the proposed rule would have reduced these companies' reported earnings per share between 0% and 41%, or approximately 15% on average. This would indicate that, on average, price to earnings multiples for these companies would have to have expanded by approximately 22% in order for these companies to have maintained their stock prices at the time of the offering. It is unclear to us that the equity market would be willing to fully grant this expansion in the price to earnings multiple and, therefore, to what extent application of the proposed rule would inhibit the ability of companies in general to attract new equity capital on acceptable terms.

Second, we feel that this proposal may have a particularly destabilizing effect on the reported earnings trends of newly public companies. The option valuation calculation method required by the current proposal requires the use of certain data, namely stock price volatility, which is not available for private companies since, by definition, they do not have publicly traded shares. In the case of these companies, the proposal provides an alternative valuation methodology. After some period of time has elapsed since the previously private company became a public company, it would presumably switch from one valuation methodology to the other. Exhibit 2 attempts to illustrate the differences in the sample companies' earnings per share using the two different methods. Our limited sample indicates that there may be differences in reported EPS ranging from 0% to 38%. These differences in earnings will produce unpredictability in earnings trends and surprises which could cause significant confusion among investors and therefore a reluctance on the part of investors to accord a stock the full value it deserves, thereby raising the cost of new equity capital.

Finally, the discrepancy which we mentioned above with regard to the different valuation techniques will make it more difficult for investors to draw comparisons of the results of several companies. A company using one valuation method may be unfairly penalized or rewarded relative to a second company which uses another valuation method. Further, we have concerns about applying techniques which are typically used to value freely tradable options and warrants, to the valuation of employee options which have different characteristics.

Although stock options may have potential intrinsic value to an employee, there is no objective basis for assigning an appropriate fair value and recording compensation expense. Stock option pricing models are imprecise and do not account for such factors as vesting and the non-transferability of stock option grants. Furthermore, alternative interpretations of option pricing models would provide divergent option valuations,

which would distort the comparability of financial statements. Moreover, any fair value pricing model assumes that there is a willing buyer (employee) and seller (employer) who would negotiate at arms length. A stock option granted to an employee is not a third-party arms-length transaction. Assigning a fair value that an employee would pay for a stock option is arbitrary at best.

In summary, Merrill Lynch believes that there is no need for a fundamental change in the current accounting practice. We would support, however, the establishment of standards for additional disclosure, such as the amount of options outstanding and the potential book value per share dilution based on varying market prices.

Doug, we would be happy to discuss further these points or any other concerns which you may have with respect to this FASB exposure draft.

Sincerely,

Matt

Exhibit 1

## Estimated Pro Forma Impact of Exposure Draft No. 127-C, "Accounting for Stock-based Compensation"

(dollars in millions except per share amounts)

| Issues | Common Stock Offering Type | Reported Earnings, Earnings per Share and Price Earnings Multiple (P/E) (a) | | | Pro forma Earnings, Earnings per Share and Price Earnings Multiple (P/E) (b) | | | % Change in Earnings | % Change in EPS | % Change in P/E (d) |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Earnings | EPS | P/E (c) | Earnings | EPS | P/E (c) | | | |
| Company A | IPO | $7.1 | $0.75 | 14.7x | $6.7 | $0.71 | 15.5x | -5.71% | -5.33% | 5.63% |
| Company 0 | IPO | 3.0 | 0.36 | 38.9x | 2.9 | 0.34 | 41.2x | -4.48% | -5.56% | 5.88% |
| Company C | IPO | 6.0 | 0.52 | 20.2x | 5.4 | 0.47 | 22.3x | -9.69% | -9.62% | 10.64% |
| Company D | IPO | 8.5 | 0.66 | 22.7x | 5.2 | 0.41 | 36.6x | -38.43% | -37.88% | 60.98% |
| Company E | IPO | 4.8 | 0.81 | 14.8x | 4.8 | 0.81 | 14.8x | -0.10% | 0.00% | 0.00% |
| Company F | IPO | 6.7 | 0.58 | 22.4x | 6.3 | 0.54 | 24.1x | -6.97% | -6.90% | 7.41% |
| Company 1 | Add-on | 4.9 | 0.58 | 35.3x | 2.9 | 0.34 | 60.3x | -40.99% | -41.38% | 70.59% |
| Company 2 | Add-on | 8.8 | 0.70 | 45.7x | 8.4 | 0.67 | 47.8x | -4.43% | -4.29% | 4.48% |
| Company 3 | Add-on | 2.5 | 0.12 | 125.0x | 2.2 | 0.11 | 136.4x | -11.27% | -8.33% | 9.09% |
| Company 4 | Add-on | 2.5 | 0.34 | 73.5x | 2.3 | 0.32 | 78.1x | -6.88% | -5.88% | 6.25% |
| Company 5 | Add-on | 12.3 | 1.10 | 32.7x | 9.2 | 0.82 | 43.9x | -25.26% | -25.45% | 34.15% |
| Company 6 | Add-on | 3.0 | 0.33 | 40.9x | 2.0 | 0.22 | 61.4x | -34.03% | -33.33% | 50.00% |
| | | | | | | | Average of IPOs = | -10.90% | -10.88% | 15.09% |
| | | | | | | | Average of Add-ons = | -20.48% | -19.78% | 29.09% |
| | | | | | | | Combined Average = | -15.69% | -15.33% | 22.09% |

Source: Deloitte & Touche. See Exhibit 3 for assumptions used in performing calculations.

(a) Latest twelve months earnings and EPS as calculated from offering prospectus. EPS weighted average shares outstanding adjusted for offering

(b) Latest twelve months earnings and EPS pro forma for Exposure Draft adjustments and offering

(c) Offering price divided by latest twelve months earnings per share

(d) Percent change in P/E such that the stock price would remain constant.

Exhibit 2

## Comparison of Pro Forma Impact of Option Valuation Method

(dollars in millions except per share amounts)

| | | Pro Forma Earnings, Earnings per Share and Price Earnings Multiple (P/E) Resulting from Option Valuation based on: | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Historic Volatility | | | Simplified Approach (a) | | | % Change | % Change | % Change |
| Issuer | Type | Earnings | EPS | P/E (b) | Earnings | EPS | P/E (b) | in Earnings | in EPS | in P/E |
| Company 1 | Add-on | $2.9 | $0.34 | 60.3x | $4.0 | $0.47 | 43.6x | 38.11% | 38 24% | -27 66% |
| Company 2 | Add-on | 8.4 | 0.67 | 47.8x | 8.6 | 0 68 | 47.1x | 2.36% | 1.49% | -1.47% |
| Company 3 | Add-on | 2.2 | 0.11 | 136.4x | 2.3 | 0.11 | 136.4x | 5.25% | 0 00% | 0 00% |
| Company 4 | Add-on | 2.3 | 0.32 | 78.1x | 2.4 | 0.33 | 75.8x | 3.52% | 3.13% | -3.03% |
| Company 5 | Add-on | 9.2 | 0.82 | 43.9x | 11.6 | 1.03 | 35.0x | 25.70% | 25.61% | -20.39% |
| Company 6 | Add-on | 2.0 | 0.22 | 61.4x | 2.5 | 0.27 | 50.0x | 23.56% | 22.73% | -18.52% |
| | | | | | | | Average = | 16.42% | 15.20% | -11.84% |

The calculations of earnings shown based on "Historic Volatility" represent an estimate of the earnings these sample companies would have reported using the method required by FASB Exposure Draft No. 127-C. The results based on the "Simplified Approach" reflect an estimate of the earnings these companies would have been required to report under the Exposure Draft had they not previously been public companies.

Source: Deloitte & Touche. See Exhibit 3 for assumptions used in performing calculations.

(a) Simplified approach does not consider stock's volatility.

(b) Offering price divided by latest twelve months earnings per share.

(c) Percent change in P/E such that the stock price would remain constant.

Exhibit 3

Accounting for Stock Based Compensation
Valuation and Implementation Assumptions

All options are earned at the date of grant, therefore expense is recognized in the current period.

Options are expected to be exercised, on average, within the first 50% - 60% of the maximum option life.

Options granted in the fiscal period prior to the offering date are representative of LTM (latest twelve months) grants.

Options granted in the fiscal year of the offering are granted after the offering unless specific information is available to the contrary.

The current volatility provided is representative of the volatility in effect at the valuation date.

The strike prices are estimated using one or more of the following approaches:

- Based on specific grant information disclosed in the proxy.
- Based on the result of dividing the aggregate value of shares awarded by the number of shares.
- Based on the prices disclosed for grants for the year in the annual report, if a range was disclosed an average was used.
- Based on the high/low trading prices for the period if specific information for the year's grants was not disclosed in the annual report.

The average annual interest rates per Bloomberg are representative of the risk-free discount rates at the date of the grant.

The shares added in the EPS calculation to reflect the offering are exclusive of any underwriters green shoe.

## TESTIMONY OF THE NATIONAL VENTURE CAPITAL ASSOCIATION
### CONCERNING ACCOUNTING FOR EMPLOYEE STOCK OPTIONS

Chairman Dodd, Senator Gramm, Members of the subcommittee, it is a pleasure to present the views of the National Venture Capital Association (NVCA) regarding the proposed changes by the Financial Accounting Standards Board (FASB) to the existing rules governing employee stock options.

I am James F. Morgan, Chairman, Founder and CEO of Morgan, Holland Ventures, a private venture capital partnership based in Boston which manages funds of $100 million. I sit on the Board of Directors of the NVCA and am Co-Chairman of its regulations and accounting committee.

The NVCA is composed of nearly 200 professional venture capital firms located throughout the United States. It was organized in 1973 to foster a broader understanding of the importance of venture capital to the vitality of the U.S. economy. NVCA's affiliate, the American Entrepreneurs for Economic Growth, represents 7,000 CEOs across America who run emerging growth companies and employ over 840,000 people. Many of these people receive stock options and will be affected directly by any changes in the accounting for stock options.

I have been a venture capitalist for almost a quarter century . . . almost as long as venture capital has been considered a separate type of business activity. During this period I, and members of my firm, have sat on the boards of hundreds of companies. I have had the fortune of helping to create highly successful companies which have been at the forefront of technology and which have employed thousands of people. I, like all other venture capitalists, have also seen companies we have directed fail after much hard work and anguish.

My years of experience in creating and growing companies has taught me many valuable lessons, the most important being that employees who are treated fairly and have an actual stake in the operation and potential profitability of a company can produce incredible results. Purist accounting theory, while it may have its place, ignores the very basic premise that companies, particularly emerging growth companies, are built and expanded by entrepreneurial people willing to take a risk for a future benefit they may or may not receive. Stock options are at the very heart of America's entrepreneurial culture . . . they are the iambic pentameter for structuring growing companies, but they are at risk of becoming an endangered species if purist accounting theory dictated by a few people (FASB Board members and staff) who are not directly accountable to any government entity, follow through with their views on stock option accounting.

I come to this issue from a very different perspective than the company CEOs I have the opportunity to sit with on this panel today. Venture capitalists such as myself, and unlike other capital sources, purchase equity securities and become actively involved at the policy-making level in the company in which we invest, generally taking a seat on the board of directors. Rather than providing just money, venture capitalists provide the entrepreneur with business and management assistance. As equity investors we are long-term builders of the company and stay fully informed and involved in all major company decisions. As active Board members we vote on stock option disbursement proposals, knowing that more stock options mean less percentage ownership for us. We vote to grant stock options, often to all employees in a company, knowing that we will rarely hold a stock option personally.

Why would venture capitalists intentionally and happily dilute their interest in a company in which they have a large financial investment? Simply because we have found that stock options are the best means for achieving extraordinary employee performance. Stock options bind the interests of the company's founders, managers and workforce. They give each employee a crucial psychological sense that they are "a part of the action" and owners in the company for which they work.

Because of the very fragile nature of the companies we back financially, the idea that these options are a compensation expense at date of grant does not fit economic reality. Nor does it accurately reflect the views of the workers who receive these options. Few employees of emerging growth companies would agree with FASB that their stock options are "probable future economic benefits". These options are nontransferable, forfeitable and of zero immediate value as they are typically granted at "market". They can't be spent! Curious compensation indeed.

Why do people decide to work for such risky companies? Once again accounting theory ignores the fact that Americans are entrepreneurs, and given the chance to "shoot for the stars" or retain a "steady job", many will opt for the challenge of working as a team and attempt to create a successful business. This is one reason why as the Fortune 500 continues to downsize its workforce, employees are finding jobs in emerging growth companies, as opposed to small business or other Fortune 500 companies.

Unfortunately, the FASB stock option proposal could choke off this expanding sector of our economy. Since FASB will require all companies to account on their P&L for grants of options, emerging growth companies will be forced to cut back on their broad use of stock options. If not, a massive negative effect on earnings will jeopardize the company's access to capital. Because the number of options issued as a percentage of shares is generally far higher for many high growth companies than for large corporations, stock option accounting changes will have a much greater effect on growing companies.

NVCA has commissioned several studies on this subject. In a survey of 582 successful venture-backed companies we found that 97% of these companies had a stock option program, and that of these more than two-thirds gave stock options to more than half of their employees. In companies founded since 1990, 78% of them gave stock options to the vast majority of their employees! However, if forced to charge the value of stock options as a compensation expense, 88% of the companies would reduce the number of employees receiving options, and of these 58% would either eliminate their stock options program or reduce it to key employees only.

Why? Another study we commissioned demonstrates that emerging growth/high technology companies would suffer major cuts in their profits under the FASB proposal of up to 60%. Other independent studies have concluded similarly. Such findings are ominous because emerging growth companies, today's job generators, will be affected most adversely. These companies continue to need additional capital to grow and prosper, but will find it increasingly difficult to secure needed capital if deterioration of their earnings statements prevent them from going public or prevent them from obtaining money from traditional sources of debt financing.

It is because of all the matters I have just raised that NVCA became concerned about FASB's intended actions in early 1992. At that time we were virtually alone in our public concern. The politics of the day dictated for many that they not touch this issue because "excessive executive compensation" was the headline across America. FASB responded to this political heat by resurrecting its long dormant project and has continued full speed ahead since that time. Frankly, NVCA has been extremely disappointed with FASB and its "deliberative process". We attempted to work with FASB as early as March of 1992 to craft an acceptable alternative, we sat on its stock compensation task force, we submitted comments to them, we made formal presentations before the entire Board, we met with FASB members on an individual basis, and we sat on various conference panels with them to discuss the matter . . . all to no avail.

FASB's public statements also give us concern that it is riding roughshod over a stated requirement that cost/benefit considerations govern in setting accounting standards. We have anecdotal evidence that implementation costs of the FASB draft proposals would increase accounting costs by ten to forty percent. FASB's response to this concern is to wave a computer disc with a calculation algorithm, as if an algorithm can gather, analyze, and present financial information. FASB argues that the cost of implementation will be studied during the phase-in period; we question the objectivity of both FASB and the accounting firm chosen to perform this analysis.

NVCA, and now an increasing number of national associations representing disparate interests, have attempted to work within FASB's established system, but all our cogent arguments have been rejected summarily. We hope that the comments many will make to FASB on its exposure draft will be read carefully and taken into account. However, public statements made by several Board members and the FASB staff give us pause as to whether the comments we submit will be given their proper deliberative review.

It is for this reason, after much internal debate and reflection, that NVCA recently announced its support of the Equity Expansion Act, S. 1175. We believe that the existing FASB process has been tainted politically by those who have forced FASB's hand by calling for the valuation of stock options. Therefore, we now believe that we must respond to the politicalization of FASB by supporting S. 1175 which directs the SEC to maintain the existing accounting standards for stock options. This legislation represents a needed counterbalance to other legislative vehicles, introduced much earlier than S. 1175, which would cripple the ability of emerging growth companies to provide stock options on a broad basis.

It is indeed ironic that we have reached this point. The theory FASB clings to throughout its arguments is that it is attempting to improve the accuracy of financial statements for the good of all users of such statements. However, virtually no one, save the FASB staff and a number of the FASB members, agrees that their proposal would help the users of financial statements. How can this theory be formulated as a "generally accepted accounting principle" when the major accounting

firms, investor and shareholder groups, company CEOs, venture capitalists, and company employees all oppose the idea?

Congress has a duty to protect the public interest, through its oversight of the Securities and Exchange Commission, whenever FASB promulgates an accounting standard. The public interest here clearly is not being served in this instance, and thus congressional intervention is warranted to protect the ability of emerging growth companies to create additional American jobs and raise additional capital.

FASB's position that it is making this change to improve financial accounting is simply wrong and must be corrected. Major distortions will result if companies, particularly emerging growth companies, are required to follow the FASB proposal. NVCA believes that FASB should reevaluate the course it has taken on this issue, particularly in light of the overwhelming opposition it has generated in the financial user community. We hope FASB returns to conducting its business in a fair, nonpolitical and reasoned manner and look forward to working with this subcommittee to make certain it does so.

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## TESTIMONY OF ROBERT GILBERTSON

PRESIDENT AND CHIEF EXECUTIVE OFFICER OF CMX SYSTEMS, INC.

on behalf of

THE AMERICAN ELECTRONICS ASSOCIATION

Mr. Chairman, my name is Robert Gilbertson, and I am the president and chief executive officer of CMX Systems in Wallingford, CT.

I am here today on behalf of the American Electronics Association. I am the former chairman of both the entire 3,000 company national association and also its Connecticut/New York Council. The AEA represents all of the Nation's largest electronic manufacturers and also 2,000 companies with 200 or fewer employees. Virtually all of our companies—large and small—rely heavily on stock options and many use employee stock purchase plans.

Mr. Chairman, in the 1970s, I earned an MBA in corporate finance from the University of Chicago and a PhD in business from Stanford. I then taught accounting at the Harvard Graduate School of Business. Therefore, I feel qualified to address whether or not the proposed FASB standard will create "pure and proper" accounting, and I do so in my written comments. I conclude that even on a theoretical basis, FASB's proposal is misguided.

But there is more at stake here than the sanctity of accounting principles. I would like to stress that CMX would not have been able to attract and motivate the talent that we have if we had not been able to share the potential equity appreciation with each and every individual. The FASB proposal would be a disaster for most of the 500 Connecticut high technology companies. All of us in the state, I should add, are proud of the leadership that you, Senator Lieberman, and Congresswoman Johnson are exhibiting on this issue.

### IMPORTANCE OF OPTIONS TO CMX

Chairman Dodd, CMX Systems is a $9 million start-up company whose 30 employees design, develop, manufacture, sell and service laser-based precision measurement and positioning products. Our sales have grown ten-fold in less than two years, mostly for export. Our growth—indeed our very existence—would not have occurred without the people we attracted with stock options. Stock options are an important vehicle by which CMX attracts, retains, and motivates its employees. The opportunity for a possible reward offsets the need for security and expensive benefits. This preserves cash for use in researching, developing, and marketing technologies.

After 90 days, every CMX employee receives stock options. That is typical in the high technology industry. In a survey released this week, ShareData Inc. found that 55 percent of the 111 high technology companies surveyed gave options to every single employee. I should add that 89 percent of the companies with less than 100 employees granted options to all employees and 72 percent of companies between 100–500 employees did the same. The percentage of high technology companies that restrict options to senior management was about 2 percent. In all four of the companies that I have run, all employees participated and eventually invested their capital to buy shares.

Stock options, in short, have well served CMX and the entire U.S. high technology industry's ability to create jobs and develop cutting edge technology. Employees at

CMX have a personal stake in how the company performs. As a result, the quality of our products are improved by stock options and our fortunes are tied to their continued use.

### The FASB Proposal and its Effect on Public Companies

Let me turn now to the FASB proposal. The effect of forcing companies to value outstanding stock options on their financial statements has been well documented for public companies. The Wyatt Group, an independent consulting group, has determined that an average high technology company would see profits reduced by almost 50 percent as a result of the FASB proposal. Even FASB concedes that its proposal would cause serious dislocations for public companies. What is less understood is the enormous impact this proposal will have on private companies, especially those like CMX, which hope to go public.

### FASB Proposal Will Not Effect Executive Compensation

First, it must be noted that executives of both public and private companies will continue to be compensated with stock whether the FASB standard is adopted or not. While I believe the SEC's new proxy rules are an effective tool in reducing the highly publicized abuses of stock options of the past, options will continue to be granted to executives in the future. Despite an earnings charge, they will still be the best way the Board of Directors can align management's interest with those of the shareholders. Thus the FASB standard would not change executive options. In privately-held companies, like CMX, many of the top officers are stock-incented not by options but by founders stock—the sale of common stock at an early stage when its value is quite low. This practice is usually restricted to the top officers in a company. The FASB's rules would not impact these stock sales.

### FASB Proposal Would Reduce Option Grants to Employees

Option grants to employees, however, *will* be reduced if the FASB standard is enacted. Because of the earnings charge, companies will reduce option grants. Unlike executives, employees are not in a position to purchase founders' stock. Unlike executives, the pressure to align company and shareholder interests through options is not so direct below the management level. Unlike executives, employees cannot bring pressure directly on the Board to continue their option grants. Rather than taking an earnings charge for stock options, the best short-term interest of the company with its employees is to minimize the total compensation charge while maximizing the employee's perceived benefit (typically by cash payments).

### FASB Proposal Will Hurt Private Companies That Seek to Go Public

The impact of the standard, of course, becomes worse as a company tries to go public. A new factor, "volatility" must be considered in the valuation computation of a public company. Volatility can easily double the computed value of an option. For a highly volatile stock, such as a biotech company, it could result in an option price equal to 95 percent of the current stock price. Moreover, employee stock purchase plans give rise to additional charges. Employee stock purchase plans are typically adopted soon after going public. These plans allow employees to designate a percentage of their wages to go towards purchasing company stock, which is sold at a 15 percent discount. Congress adopted these rules to promote employee ownership. Companies use them to raise capital without the costs of a stock offering. The proposed standard would require an earnings charge for this discount.

The FASB standard then will hurt a company trying to go public—reducing its value and possibly delaying its offering. To go public, a company must be fortunate enough to have several things all fall into place—the products have to work; the customers have to like them; the company has to be profitable; and the future prospects of the company must be bright. The significant earnings charges which will hit a public company may push back the point when it finally turns profitable. More significantly, it will reduce expected future earnings. And it is these earnings on which a company's stock is based.

Let's say I'm fortunate enough that the impact of the FASB standard on CMX is that my future earnings will be reduced by only 20 percent rather than the 50 percent estimated impact I mentioned on public companies. My stock price will be reduced by 20 percent, which means I will only be able to raise 80 percent of the funds I would have otherwise raised in the public stock market. This makes my company that much less strong, with that much less cash to survive the next downturn, to invest in R&D spending or to buy capital equipment.

The FASB standard makes the playing field uneven for small- and medium-sized public companies. The real impact to this standard is not when a company is private. Because the valuation is calculated differently and because private companies don't have stock purchase plans, the impact is not nearly as great. But once public, a small- or medium-sized company must compete for talented individuals against those same private companies who can offer more options, that have more potential upside with less consequences. At the same time, these small- and medium-sized companies have to compete against extremely large companies who often offer more stable employment, and more extensive benefit plans.

The hardest part of surviving as a newly-public company is developing the "next" product. This takes a continuous infusion of new talent. The two weapons most commonly used by small- and medium-sized public companies in competing against start-ups and large companies—broad-based stock option grants and an employee stock purchase plan—will become very expensive. The FASB's standard will make it harder, if not impossible to compete for that talent.

### Flaws in FASB's Methodology

I want to now turn to items associated with the FASB's assumptions and its proposed accounting methodology. I will focus on two of the more significant issues surrounding the FASB's proposal at this time. The first item is the issue of whether the issuance of employee stock options is a capital transaction or compensation expense to the entity that issues the options.

### Employee Stock Options: Capital Compensation

The FASB proposal characterizes 100 percent of the value assigned to employee stock options as compensation which should be charged against financial statement earnings. AEA believes that the most significant component of the value of an employee stock option is the ownership interest granted to the employee. Although a portion of the option value may be attributable to compensation, it is not possible to accurately value the compensation element and the FASB should not compound the fundamental arbitrary value existing pricing models assign to employee stock options by a further arbitrary classification of the value as all compensation. Because employee stock options are primarily capital, option grants should be considered primarily as capital transactions and not charged against financial statement earnings.

Corporate shareholders authorize management to grant stock options to company employees to give employees an equity ownership interest in the company and align the employees' interests more closely with the interests of the external shareholders. AEA member company employees generally do not view option grants, which are highly restricted and subject to significant market risks, as compensation when received. Option grants cannot be relied upon to pay the mortgage or make the car payment. Employees simply appreciate the opportunity to share in the potential rewards from owning an equity interest in their companies.

Stock options allow employees to build wealth through "sweat equity" and provide the incentive for employees to make the substantial additional commitment required to build a successful company in today's extremely competitive marketplace. Entrepreneurs who create businesses are often rewarded for years of hard work by realizing the increase in the value of their ownership interests in their companies. Stock options permit entrepreneurs to share this opportunity with the employees who help them succeed. Both the entrepreneurs and employee option holders are realizing "capital compensation" for their efforts. Yet the FASB proposal would account for the options as compensation while accounting for the entrepreneurs "founders" interest as capital. AEA strongly believes that both transactions should be accounted for as capital.

### Reliability of Valuation Models

The second issue that I would like to focus on relates to the option valuation methodologies that the FASB proposes using to measure the fair value of employee stock options—assuming that these options are accounted for as compensation. The FASB, in its Exposure Draft, contends that the value of stock options awarded to employees can be reasonably estimated using existing stock option pricing models, such as the Black-Scholes or binomial models.

I strongly disagree with the FASB's assertion that the value of employee stock options can be reasonably estimated using available option pricing models. The proposed valuation methods that are available today have severe deficiencies that would lead to the inappropriate recognition of overstated option values.

Existing valuation models were created to assist investors in making their investment decisions and are not applicable to scenarios involving employee stock options. These models were created to value stock options which are short-term in nature and freely tradable in an open market. Employee stock options, on the other hand, do not share in these characteristics. Rather, employee stock options are long-term in nature, subject to forfeiture and are nontransferable.

In addition to the issue of nontransferability of employee stock options, the option valuation models do not take into account liquidity problems that result from an employee's inability to avail themselves of market opportunities that result from the volatility of a company's stock price. These liquidity problems come in several different forms, including:

- Vesting limitations.
- Insider trading restrictions on employees which are applied to any employee who is judged to be an insider. These restrictions result in "black-out" periods which place severe limits as to when insiders may trade in their company's shares.
- Informal encouragement placed upon management to hold options for longer periods.

In fact, these options are given to employees with the expectation that they are to serve the purpose of aligning employee interest with those of the shareholders over a lengthy period of time before exercise. In some companies, the expectations to hold options for a long period of time is modest and casual; in other instances it is more specific.

The FASB's proposed accounting attempts to address the factors of nonliquidity and nontransferability, but it addresses these factors through the context of a somewhat arbitrary adjustment to existing option valuation models. As a proposed solution to these issues, the FASB allows the option exercise period component of these valuation models to be adjusted to the expected life of the option rather than the maximum option term. The life of an employee stock option often is shorter than the maximum exercise period results in a modest reduction to the value assigned to options using existing pricing models.

While I agree that addressing the difference between the expected option life and maximum option period is a relevant adjustment for purposes of valuing employee stock options, it still does not take into account the nontransferability and nonliquidity aspects of employee stock options and the significant impacts that these factors have on valuations. The presence of these factors in employee stock options indicate that a further downward value adjustment, far greater than the FASB's proposed solution, is needed in order to reasonably estimate the value associated with employee stock options. Not considering these factors in the valuation of employee stock options would result in an overstatement of option value and a potentially significant misstatement of a company's financial results.

## Summary

In summary, it is clear why the FASB standard is generally accepted by no one. As an entrepreneur with 39 employees, I can tell you that the FASB proposal will have a major and negative impact on our decision to go public. That will mean less growth and fewer jobs for the people of Connecticut. Despite its own charter that requires it to weigh the economic consequences of its decisions, FASB has pursued this issue from the perspective of proper accounting policy. Even from this narrow perspective, FASB rests its case on questionable assumptions and flawed methodologies.

The AEA urges Congressional action. We do so reluctantly. Accounting policy is generally better left to accountants. The problem is that no one is weighing the economic consequences of a proposal that will devastate the entrepreneurial culture of an entire industry as well as its ability to create new jobs. It is for this reason that the FASB proposal has become the most pressing public policy issue in AEA's fifty year history. The AEA strongly endorses the legislation by Senators Lieberman and Mack, S. 1175 and the resolution by Senator Bradley, S. Con. Res. 34. We also believe that the legislation introduced by Senator Levin, S. 259, is moving exactly opposite from the direction Congress should be headed. Finally, the AEA applauds your decision, Senator Dodd, to bring this issue to the attention of Congress and the American people.

## TESTIMONY OF DENNIS R. BERESFORD

### Chairman, The Financial Accounting Standards Board

Dear Senator Lieberman, members of the Financial Accounting Standards Board (the FASB or the Board) and its staff routinely consult with Members of Congress, their staffs, and other government officials on matters involving financial accounting. For example, FASB members and staff met with Senator Levin both before and after the introduction of his proposed legislation, Senate Bill 259, which also addresses accounting for employee stock options.

The attachment to this letter discusses the accounting issues (we have not addressed the tax issues) raised in your proposed legislation, Senate Bill 1175, and issues raised in remarks introduced in the *Congressional Record.* My comments in this letter address an issue that is more important than any particular legislation or any particular accounting issue: Why we have a defined process for setting financial reporting standards and why it is harmful to the public interest to distort accounting reports in an attempt to attain other worthwhile goals.

### Financial Reporting

Markets are enormously efficient information processors—when they have the information and that information faithfully portrays economic events. Financial statements are one of the basic tools for communicating that information. The U.S. capital market system is well-developed and efficient because of users' confidence that the financial information they receive is reliable. Common accounting standards for the preparation of financial reports contribute to their credibility. The mission of the FASB, an organization designed to be independent of all other business and professional organizations, is to establish and improve financial accounting and reporting standards in the United States.

Investors, creditors, regulators, and other users of financial reports make business and economic decisions based on information in financial statements. Credibility is critical whether the user is an individual contemplating a stock investment, a bank making lending decisions, or a regulatory agency reviewing solvency. Users count on financial reports that are evenhanded, neutral, and unbiased.

An efficiently functioning economy requires credible financial information as a basis for decisions about allocation of resources. If financial statements are to be useful, they must report economic activity without coloring the message to influence behavior in a particular direction. They must not intentionally favor one party over another. Financial statements must provide a neutral scorecard of the effects of transactions.

### Economic Consequences of Accounting Standards

The Board often hears that we should take a broader view, that we must consider the economic consequences of a new accounting standard. The FASB should not act, critics maintain, if a new accounting standard would have undesirable economic consequences. We have been told that the effects of accounting standards could cause lasting damage to American companies and their employees. Some have suggested, for example, that recording the liability for retiree health care or the costs for stock-based compensation will place U.S. companies at a competitive disadvantage. These critics suggest that because of accounting standards, companies may reduce benefits or move operations overseas to areas where workers do not demand the same benefits. These assertions are usually combined with statements about desirable goals, like providing retiree health care or creating employee incentives.

There is a common element in those assertions. The goals are desirable, but the means require that the Board abandon neutrality and establish reporting standards that conceal the financial impact of certain transactions from those who use financial statements. Costs of transactions exist whether or not the FASB mandates their recognition in financial statements. For example, not requiring the recognition of the cost of stock options or ignoring the liabilities for retiree health care benefits does not alter the economics of the transactions. It only withholds information from investors, creditors, policy makers, and others who need to make informed decisions and, eventually, impairs the credibility of financial reports.

One need only look to the collapse of the thrift industry to demonstrate the consequences of abandoning neutrality. During the 1970s and 1980s, regulatory accounting principles (RAP) were altered to obscure problems in troubled institutions. Preserving the industry was considered a "greater good." Many observers believe that the effect was to delay action and hide the true dimensions of the problem. The public interest is best served by neutral accounting standards that inform policy rather than promote it. Stated simply, truth in accounting is always good policy.

Neutrality does not mean that accounting should not influence human behavior. We expect that changes in financial reporting will have economic consequences, just as economic consequences are inherent in existing financial reporting practices. Changes in behavior naturally follow from more complete and representationally faithful financial statements. The fundamental question, however, is whether those who measure and report on economic events should somehow screen the information before reporting it to achieve some objective. In FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (paragraph 102), the Board observed:

> Indeed, most people are repelled by the notion that some "big brother," whether government or private, would tamper with scales or speedometers surreptitiously to induce people to lose weight or obey speed limits or would slant the scoring of athletic events or examinations to enhance or decrease someone's chances of winning or graduating. There is no more reason to abandon neutrality in accounting measurement.

The Board continues to hold that view. The Board does not set out to achieve particular economic results through accounting pronouncements. We could not if we tried. Beyond that, it is seldom clear which result we should seek because our constituents often have opposing viewpoints. Governments, and the policy goals they adopt, frequently change.

## Standard Setting In the Private Sector

While the SEC and congressional committees maintain active oversight of the FASB to ensure that the public interest is served, throughout its history the SEC has relied on the Board and its predecessors in the private sector to establish and improve financial accounting and reporting standards. In fulfilling the Board's mission of improving financial reporting, accounting standards are established through a system of due process and open deliberation. On all of our major projects, this involves open Board meetings, proposals published for comment, "field testing" of proposals, public hearings, and redeliberation of the issues in light of comments.

Our due process has allowed us to deal with complex and highly controversial accounting issues, ranging from pensions and retiree health care to abandonment of nuclear power plants. This open, orderly process for standard setting precludes placing any particular special interest above the interests of the many who rely on financial information. The Board believes that the public interest is best served by developing neutral accounting standards that result in accounting for similar transactions similarly and different transactions differently. The resulting financial statements provide as complete and faithful a picture of an entity as possible.

Corporations, accounting firms, users of financial statements, and most other interested parties have long supported the process of establishing accounting standards in the private sector without intervention by Congress or other branches of government. Despite numerous individual issues on which the FASB and many of its constituents have disagreed, that support has continued. The resulting system of accounting standards and financial reporting, while not perfect, is the best in the world.

## Conclusion

We understand that there are a number of people who believe that their particular short-term interests are more important than an effectively functioning financial reporting system. We sincerely hope, however, that you and others in the Congress will review the reasons that have led generations of lawmakers and regulators to conclude that neutral financial reporting is critical to the functioning of our economic system and that the best way to achieve that end is to allow the existing private sector process to proceed. We respectfully submit that the public interest will be best served by that course. As former SEC Chairman Richard Breeden said in testimony to the Senate Banking Committee in 1990:

> The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose.

The attachment to this letter discusses your proposed legislation. It also describes some aspects of our project on stock compensation and the steps in our due process procedures that remain before the project will be completed. In your remarks in the Congressional Record, you said that you will address future issues, including an examination of the current accounting treatment of employee stock options, over the next weeks and months. We would be pleased to meet with you or your staff to dis-

cuss these topics and the details of our project. I will phone your appointments person in the next two weeks to see if it is convenient for you to meet with me.

## ATTACHMENT

### Issues Raised in the Proposed Legislation

*Inconsistent Accounting for Similar Economic Events*

For many years, accounting principles have required that transactions effected through the issuance of equity securities be recognized in financial statements. Section 4 of Senate Bill 1175 (the Bill) would preclude recognition of any expense or other charge resulting from the grant, vesting, or exercise of an option or other right to acquire equity securities granted "in connection with the performance of services." We infer from this passage that options used to acquire an asset, perhaps a building or another company, would still result in the assets being recorded at fair value—as required by existing generally accepted accounting principles (GAAP). Thus, options used to acquire materials to construct a building would be recognized as a cost of the building, but options used to pay the architect to design the building would not. Yet, both are equally necessary to construct the asset. Why should one be recognized and not the other?

*Accounting for Options Settled in Cash*

Section 4 would apply to any "options or other rights to acquire" employer equity securities, including options that grant the holder a right "to receive property at the time of the exercise of the option" (Section 2). "Property" usually includes cash. Paying cash to an employee requires that the accountant record a decrease (or credit) in cash and a charge (or debit) to some other account. Because the proposed legislation precludes any expense or other charge, the only remaining alternative is a direct reduction in shareholders' equity. As a result, a cash bonus plan tied in some way to the price of the employer's stock would not decrease reported income. A cash bonus of the same amount but unrelated to stock performance would decrease reported income.

*Amending the Securities Act of 1934*

Section 4 would amend the Securities Act of 1934 and would direct the Securities and Exchange Commission (the SEC) to neither "require or permit" recognition of expense resulting from stock options. The securities acts apply only to public companies. The accounting for private companies would be unaffected. This would create an unfortunate double standard because private companies use stock options as part of employee compensation in the same way as public companies.

### Issues Raised in the Congressional Record

Comments in the June 29 issue of the *Congressional Record* raise additional accounting issues on which we wish to comment.

*The Board Is Responding to Political Pressure*

Several references are made to the Board's responding to political pressure and to publicity about "fat cats." Nothing could be further from the truth. Pressure on the Board, political and otherwise, has been largely directed against any accounting recognition of employee stock options. If the Board were responding to political pressure, it would either decline to address this issue altogether or find a more politically palatable solution. Further, we are aware of strong positions in different directions among members of Congress and our other constituents. It would be impossible to please everyone, even if we wanted to.

The Board added this project to its agenda in 1984 because the current rules for accounting for stock-based compensation, including stock options, are biased. Depending on the type of option issued, the accounting is substantively different. If a certain number of stock options are issued with an exercise price equal to market price, the type most commonly issued today, no expense is recognized. However, similar options could be issued with a performance condition, for example, a target level of sales must be achieved, before they are earned. The "performance option" would result in expense if the stock price rises.

This financial reporting result is simply not credible and has discouraged the use of performance-based options. All stock options, with or without performance conditions, are a form of compensation and that compensation should be included in an entity's reporting of its costs. The Board's proposal would apply the same basic accounting provisions to all types of options.

*The Board's Proposal Increases the Cost of Stock Options*

Some of the comments allege that the Board's Exposure Draft would increase the cost of employee stock options and make broad-based plans "prohibitively expensive." This is incorrect. The cost of a stock option would be exactly the same after an FASB Statement as it was before. The only difference is that the cost would then be recognized in the company's financial statements. One might make the same argument about any economic transaction. For example, some have argued that recognizing a company's obligation for retiree health care benefits makes the benefits prohibitively expensive. However, the obligation and the cost were there before GAAP required recognition.

All that has changed is that a company's financial statements now present a more complete picture of its obligations. Moreover, there should be no reason to reduce or eliminate stock option plans if the real economic benefits received from them exceed the cost to the company and its shareholders.

*The Board's Proposal Requires Estimates of Future Value*

The comments observe that, ". . . accurately estimating the *future value* (emphasis added) of employee stock options is nearly impossible." That is probably true, but the Board's Exposure Draft would require no such estimate. The objective would be to measure the value of the option *when granted.* That estimate does not require "predicting the company's future earnings, cash flow, market share, [and] capital spending, as well as future government policy." The option-pricing models described in the Exposure Draft do require some estimates, but so do most other accounting measurements. Accountants do not shrink from measuring the cost of pensions, the depreciation of fixed assets, collectibility of loans, insurance claim liabilities, or a host of other amounts because they require estimates. The measurements proposed in the Exposure Draft are no more subjective and difficult than many accounting measurements.

Compensation committees routinely use option-pricing methods in the design and administration of compensation packages. Without some notion of value, how can a company decide whether to issue 100, 1,000, or 100,000 options? Option-pricing methods are at the heart of many transactions in today's global marketplace. Option traders in financial markets and companies that use strategies to hedge certain risks often employ methods similar to the option-pricing models described in the Board's Exposure Draft.

To the extent it would affect financial reporting, the proposed legislation appears to be an attempt to change the measuring system to encourage the use of stock options. There is no question that there are significant benefits from the use of stock options or other forms of stock-based awards as compensation. The question is whether that form of compensation should be reported differently from all other forms of compensation and differently from all other stock or stock-related transactions. Employees also benefit from cash compensation. It would be equally inappropriate to encourage employers to pay more cash compensation to certain groups by omitting the cost from financial reports. The Board believes that complete reporting of an enterprise's financial activity must take precedence over encouraging one activity or another.

OTHER COMMENTS

The Board did not undertake its project for the sake of "accounting purity." Our goal is to have a financial reporting system in which all financial statement users can be confident that financial information reports the economic effects of a company's transactions in a neutral and unbiased manner. We believe that financial reporting will be improved by requiring the recognition of all compensation costs, including stock options.

We recently sent you a copy of our Exposure Draft on stock compensation, which includes not only the proposed accounting provisions, but also the basis for the Board's conclusions. Attached is a brief summary of the document. The Board has done a great deal of work to date, but the process is far from over at this point, and in some respects, it has only just begun. We provided for a six-month comment period, during which we, in conjunction with KPMG Peat Marwick, will be conducting a field test of the effects of adopting the proposal. We also will be speaking to organizations and meeting with interested parties to describe the proposed accounting and to learn about implementation issues. After the comment period and completion of the field test, we will hold public hearings to receive input from the most interested individuals and groups.

After Board members have read all of the comment letters, studied the results of the field test, and listened to public hearing testimony, we will redeliberate all

of the issues in the Exposure Draft and reassess earlier decisions based on the additional information we receive. The stock compensation project is a controversial one, and we assure you that this is a serious issue for us. We will continue to keep an open mind as we progress with our due process.

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## TESTIMONY OF JAMES J. LEISENRING

### Vice Chairman, The Financial Accounting Standards Board

Dear Senators Dodd and Gramm, the Financial Accounting Standards Board (the Board) is pleased to participate in the subcommittee's October 21 hearing on accounting for employee stock options. Our written statement, including a two-page summary, is attached, along with supporting documents that describe the Board and its operations. The response was prepared by members of the Board's staff and reviewed by the members of the Board.

As we have informed subcommittee staff, I will represent the Board at the hearings. I will be accompanied by Diana W. Willis, project manager of our stock compensation project, and Wayne S. Upton, Jr., our project manager who handles liaison with government.

The members and staff of the Board would be pleased to provide any additional information that you think would be helpful in your inquiry.

### FASB Summary Remarks

The Financial Accounting Standards Board welcomes the opportunity to discuss accounting for stock-based compensation before the Subcommittee on Securities. You asked that our testimony address three questions. The first asks about the extent to which companies use options. We know that options are widely used as compensation; otherwise, there would be little interest in how to account for them. We also know that fixed options are used more than performance-based options due in large part to accounting considerations rather than economic or motivational concerns. We understand that the most extensive use of stock options is in start-up enterprises.

The impact of our proposal, which is the subject of your second question, will vary widely from company to company. We are conducting a field test to learn more about the financial effects on different companies. Requiring expense to be recognized for fixed options would be a significant change. Our proposal, however, would often result in less expense for performance-based options than is recognized now. Because our proposal would level the playing field for different plans, one important impact would be to remove accounting as an overriding consideration in choosing between fixed and performance-based plans.

Your third question asks about the merits of the accounting principles and concepts on which our proposal is based. That is discussed in the remainder of this summary.

The FASB was formed as an independent, private-sector body whose sole purpose is to improve financial reporting. The leaders of the profession took steps to ensure the FASB's independence because they recognized that there would be issues for which the short-run interests of powerful individuals would conflict with the long-run objective of relevant, credible financial reporting. Financial statements are a basic tool used for communicating information about economic events to capital markets. An efficient economy requires good financial information because investors, creditors, regulators, and others base decisions on information contained in financial statements. To make the best economic decisions, they must have financial statements that neither omit information nor color the message to influence behavior in a particular direction.

Some of our constituents say that we should consider the perceived economic consequences of our standards. They contend that we should not act if a new accounting standard might have an effect that they consider undesirable. Such comments may at first seem plausible when made in the name of job creation, U.S. competitiveness, and encouraging start-up businesses. However, pursuing economic goals by slanting the message contained in financial statements would succeed only in impairing the usefulness and credibility of those statements. Costs exist whether or not we recognize them in financial statements. Economic goals are best achieved directly by subsidies, tax policy, and the like. The FASB believes that capital markets are best served by unbiased financial statements designed to inform policy makers, rather than to promote policies. Decision-makers need financial statements that "tell it like it is."

Despite what you may have heard, we are reconsidering current accounting for stock compensation because our constituents, including the AICPA, the SEC, most of the major public accounting firms, and several corporations asked us to—not because of political pressure. They told us that transactions with substantially the same economic effects often received drastically different accounting treatment under current standards. We agreed that the current accounting for stock compensation is biased, lacks credibility, and therefore requires improvement.

With the exception of fixed, at-the-money employee stock options, all other transactions in which equity instruments are issued are recognized in financial statements. Moreover, all other forms of compensation, including salaries, pensions, restricted stock, and health care benefits, are measured and recognized as costs in financial statements except for stock options.

Have we made up our minds that stock options are compensation that should be recognized? Yes. Have we made up our minds about how to exactly measure the compensation expense? No. This is the third time in the past 50 years that an accounting standard-setting body has considered stock compensation. We agree with our predecessors that stock options granted to employees are compensation. The debate has been and continues to be how to measure the compensation. We encourage continuing debate and research on measurement.

Our proposal acknowledges that employee stock options are different from traded options because employee options are nontransferable, usually have vesting requirements, and their terms are generally longer. We have adjusted for those differences in the estimates of fair value to be made under our proposal. We would be delighted if continuing debate results in better adjustments.

Due process for this project is far from complete. We provided for a six-month comment period ending December 31, 1993, during which we are talking to many people. We also are conducting a field test of the proposals. In March 1994, we will hold public hearings to hear more from interested individuals and groups.

After Board members have read the comment letters, studied the results of the field test, and listened to public hearing testimony, we will redeliberate all of the issues in the Exposure Draft and reconsider our earlier decisions based on the additional information we receive.

We hope that you can accept the broad objective of credible, reliable financial reporting and allow the process designed to achieve that objective to proceed.

## Accounting for Stock-based Compensation

The Financial Accounting Standards Board (the FASB or the Board) welcomes the opportunity to discuss accounting for stock-based compensation, primarily employee stock options, before the Subcommittee on Securities. The Board has followed the legislative initiatives related to employee stock options with interest, and members of our staff have provided information and discussed related issues with subcommittee staff. Our chairman, Dennis R. Beresford, wrote to Senator Lieberman in response to his proposed Senate Bill, S. 1175, "Equity Expansion Act of 1993." A copy of that letter is attached.

The FASB is recognized by corporations, the American Institute of Certified Public Accountants (AICPA), and the Securities and Exchange Commission (SEC), as the designated organization for the setting of accounting standards. In fulfilling the Board's mission, accounting standards are established through a system of due process and open deliberation. All of our Board meetings are open to the public. After extensive research and deliberation of an accounting issue, we publish a proposed accounting standard (Exposure Draft) for comment. On a major project, like stock compensation, we then hold a public hearing and conduct "field tests" of the proposals before redeliberating issues and establishing a new accounting standard. All interested parties are invited to share their concerns and criticisms with us as part of our open process. All Board members and project staff read every letter sent to us. In addition all letters to us are made part of the project's public record, available for any interested party.

This private-sector system, with active oversight by the SEC and congressional committees, has created a credible financial reporting system on which the U.S. markets rely. Users of financial statements must be confident that companies report similar transactions similarly and that financial reporting standards are not influenced by special interests or factors that would color financial reports to favor one party over another or to encourage a specific type of transaction over another. In other words users need to be confident that financial reporting standards are neutral. The SEC, corporations, accounting firms, and others have long supported the FASB and its predecessors, even if they disagree on individual issues.

We have attached copies of *An Introduction to the FASB,* and *FACTS about FASB,* descriptions of the Board and its mission, to this submission. We have also attached a summary of the Exposure Draft, *Accounting for Stock-based Compensation.*

*Why is the FASB Proposing a Change in the Accounting for Employee Stock Options?*

As with other projects on the Board's agenda, the accounting for stock compensation is being revisited because our constituents asked us to do so. In 1984, the AICPA sent us an Issues Paper that outlined problems with current accounting. Other organizations and corporations also encouraged us to reconsider the current rules. The current accounting for employee stock options, set forth in APB Opinion No. 25, *Accounting for Stock Issued to Employees,* is both internally inconsistent and inconsistent with the accounting for all other types of compensation.

There are two major problems with current accounting. First, most options issued today are what we call fixed options, which means that the exercise price and the number of shares an individual employee may receive are both known on the day of grant. By issuing fixed options for which the exercise price equals the stock price on the date of grant, a company avoids making an accounting entry, regardless of the quantity of options. Current accounting standards conclude that the issuance of stock options is compensation, however, the measurement method is intrinsic value, the difference between the option's exercise price and the market price of the stock on the measurement date. For fixed options, intrinsic value is zero at the date of grant, which is the amount of compensation expense measured, resulting in no accounting recognition of the transaction.

Something of value has been transferred to employees, but current accounting ignores that economic reality. Stock options are valuable rights because employees are able to take advantage of stock increases over a long period without being exposed to any risk of loss if the stock price decreases. Fixed options are part of employee compensation as are all other forms of compensation, including salaries, health benefits, and pensions. Yet, the compensation expense from fixed options is not recognized in measuring net income.

The second problem is the current distinction between fixed and "variable" options. Variable options are those in which either the exercise price of the option or the number of shares to which an employee will become entitled is unknown at the date of grant. For example, some variable options include a performance target that must be reached before the options are earned. Under current accounting, variable options usually result in compensation expense equal to the difference between the exercise price of the option and the market price of the stock on the date that the performance target is achieved. Variable options are obviously worth less than fixed options because a performance goal must be reached before they can be exercised, but the financial reporting for the two types of options implies just the opposite. This inconsistent measurement of two similar transactions that can be economically equivalent simply is not credible.

As a result of this anomaly (no expense charge for a more valuable option, but a charge for a less valuable option), accounting considerations, rather than economic and motivational considerations, have been the overriding factor in designing many compensation programs. We are told that performance options, options with indexed exercise prices, and similar plans face heavy resistance from management because of the expense charge required. Fixed options are widely used because of the favorable accounting result—zero expense—even though a performance option might be a better employee incentive.

*What is the FASB's Proposal?*

On June 30, 1993, the FASB issued an Exposure Draft, *Accounting for Stock-based Compensation,* that proposes new accounting for employee stock options and other awards which are based on the price of a corporation's stock.

Generally, we propose that employee stock options be treated like all other types of compensation and that their value be included in financial statements as part of the cost of employing people. The Exposure Draft proposes that all types of stock options, fixed or variable, be recognized as compensation based on the fair value of the options. Fair value for public companies would be estimated using an option-pricing model and the stock price at the date of grant, with adjustments for the unique characteristics of employee stock options, including nontransferability, vesting requirements, and performance conditions, if any. No adjustments after the grant date would be made for changes in the stock price—either up or down. Nonpublic companies would be permitted to use a "minimum value" method to estimate the value of their options. That method does not consider the volatility of the stock for which the employee is granted an option.

For both public and nonpublic companies, the value of the award would be charged to expense over the period in which employees provide the related service, which is usually the vesting period. Applying the current requirements on accounting for income taxes would result in a charge to expense that is net of taxes, which would reduce the effect on net income.

Our Exposure Draft would change current practice to recognize expense for fixed options for which none now is recognized. The proposed accounting, however, often would result in less expense when applied to variable option plans. The maximum amount of expense resulting from a variable plan would be determined at the date of grant, rather than varying throughout the option period with stock market swings as it does today. The proposed standard would level the playing field for different types of plans, and companies would be able to select compensation programs that achieve their desired economic objectives without overriding concerns about accounting results.

Because existing compensation plans were developed with the current accounting requirements in mind, the proposal would apply prospectively to grants made after December 31, 1996. That will give companies time to rethink their compensation programs and time to work with option-pricing methods. During that time, from 1994 to 1996, the income statement and earnings-per-share effects would be disclosed in the notes to financial statements.

*What Happens Next?*

The comment period on the Exposure Draft ends December 31, 1993. During this time we have been and will continue to speak to various organizations and meet with interested parties. Public hearings will be held in Connecticut and California in March 1994. We expect that almost 60 people will testify at the hearings.

In conjunction with KPMG Peat Marwick, we are conducting a field test of the proposal. Volunteer companies, including small and large, nonpublic and public, will apply the provisions of the Exposure Draft to awards granted in 1990–1992. The primary objectives of the field test are to learn about the potential effects of the proposal on individual companies by measuring the value of options granted during those years, identify implementation issues, and see whether the proposal is clear enough for companies to understand and apply.

After Board members have read all of the comment letters, studied the results of the field test, and listened to public hearing testimony, we will redeliberate all of the issues in the Exposure Draft and reassess earlier decisions based on the additional information we receive.

*Has the FASB Considered the Economic Impact of This Proposal?*

Expense recognition for all employee stock options would be a significant change in financial reporting for some companies. This new information undoubtedly will affect some decisions. Helping investors, creditors, and others who use financial statements make more informed decisions is the purpose of all financial information. A recent project of the Board resulted in new accounting for retiree health care benefits. As a result of the new information that resulted from that standard, many employers for the first time understood the magnitude of their obligations. They then took steps to better manage their exposure to future costs.

Some critics suggest that the FASB should consider possible actions that might result from new accounting information. If such potential actions are considered negative, those critics say that the FASB should not require the new information to be reported. When these comments are made in the name of job creation, U.S. competitiveness, and encouraging start-up businesses, they may at first glance seem plausible. However, such a policy would require the Board to abandon its neutral position in setting accounting standards that are free from intentional bias toward a predetermined result.

To color the message contained in financial statements in a way designed to achieve a "greater good" would only succeed in impairing the credibility of the entire financial reporting system. The FASB does not attempt to achieve particular economic results through accounting pronouncements. We have neither the authority nor the competence to weigh the various, often conflicting, national goals. More importantly, financial reporting is not the appropriate arena in which to seek achievement of goals like job creation, improved U.S. competitiveness, or more successful start-up enterprises. Goals like those are best achieved directly through subsidies, tax incentives or other direct means. Financial statements best serve the capital markets when they report the economic effects of transactions as accurately and even-handedly as possible.

The stock market's reaction to information about the cost of employee stock options is unpredictable. Some companies and analysts say that the value of employee

options is already reflected in their stock prices. Other companies say that their stock price will decline with a decline in reported income. In his as yet unpublished article, "Why (and How) to Value Employee Stock Options," Craig McCann, Senior Economist, Economic Analysis Corporation, discusses this issue.

> [Accounting] research offers clear policy guidance. If accounting numbers don't matter because the markets always see through them, then there is no harm in getting the accounting right. If the accounting numbers do matter, then it is very important to get the accounting right. So, get the accounting right. Moreover, even if the markets can pierce the veil of accounting, surely there is merit in promoting consistency in reporting, simply to conserve on the efforts that small investors, financial analysts, and policy makers must make in reading the reports and their footnotes and fine print in order to evaluate firm performance.

Some have told us that companies will reduce the use of stock options, which will hinder their ability to hire, retain, and motivate skilled employees if the proposed accounting for stock options is required. However, companies also tell us that options provide significant benefits, including giving employees an ownership incentive, requiring no cash outlay, and serving as a potential source of capital. Those benefits would not be eliminated as a result of the FASB proposal.

The economic cost of stock options is the same regardless of the accounting. Recognizing compensation cost for stock options would not affect a company's cash flow; thus, the cash available to fund research, development, and investment is not affected. There should be no reason to eliminate a stock option plan if the real economic benefits received exceed the cost to the company and its shareholders.

*Aren't Employee Stock Options Equity Transactions That Do Not Result in a Cost to the Company?*

Current accounting recognizes all other transactions involving the issuance of stock in exchange for goods and services. The issuance of employee stock options is the only equity transaction that is not recognized under current accounting rules. If all equity transactions did not have to be recorded, companies would not have to record equity instruments issued in other exchanges, such as those for outside professional services, capital purchases, or business combinations.

Employee stock options are part of employee compensation packages, as are cash salaries, bonuses, health benefits, and pensions. Stock options are not free. If a company sold options in the marketplace and then paid bonuses to their employees using the cash proceeds from that sale, no one would question that a cost should be reported for employee services. The FASB proposal simply looks through such a transaction and concludes that options are a form of compensation that should be recognized. Financial statements are incomplete without reporting all costs incurred, regardless of the form of payment.

Some of our critics say that stock options are compensation paid to employees not by the company but by its shareholders who agree to share future stock appreciation with employees. However, employees provide services to the company—not directly to individual shareholders—as consideration for their options. If a shareholder paid operating expenses on behalf of a company, our existing accounting framework would require the company to record that transaction. The compensation cost stemming from the issuance of stock options likewise belongs in the company's financial statements.

Some have suggested that stock options are a superior form of compensation that should be encouraged. Others say that employees place a lower value on stock options than cash. Both of those assertions may be true, but the same might be said of a variety of forms of compensation. Health care benefits, pensions, on-site child care, and a variety of benefits all may provide important employee motivation, and any of these may be valued more highly by some employees than others. Yet no one argues that the cost of those benefits should be excluded from income statements.

*Isn't the Real Impact of Employee Stock Options Already Reflected in Earnings-per-share Dilution? Wouldn't the FASB Expense Charge Be Double Counting?*

A transaction that results in an expense and more shares outstanding properly changes both the numerator and the denominator in the earnings-per-share calculation by reducing earnings and increasing the number of shares outstanding. Under current accounting, if a company issues shares of stock, rather than stock options, to employees in exchange for their services, compensation expense is recognized for the services obtained, measured as the fair value of the stock issued, and those shares are included in an earnings-per-share calculation. Our proposal would merely treat stock options the same as other equity instruments issued for goods or services in measuring net income and computing earnings per share.

The current dilution calculation for options outstanding does not in any way capture the cost incurred when options are issued to employees. The compensation cost arising from issuing fixed options should be recognized in earnings just as it currently is for variable options. If, and when, the stock price increases sufficiently for the employee options to be dilutive, those options are properly included in outstanding shares for earnings-per-share purposes.

*No One Knows the Value of Employee Stock Options the Day They are Granted. Don't They Have Value Only if an Employee Ultimately Realizes a Gain Upon Exercise?*

An option gives the holder the right to share in the appreciation of a company's stock, the same as any shareholder, but without having to pay the full price of the stock up front. Investors routinely buy stock options, warrants, and long-term options (LEAPs) in the markets today. Investors pay cash to acquire options, and employees provide their services to the company to acquire them.

Most traded options ultimately expire worthless, but that does not mean that they had no value when they were issued. The FASB's approach is to estimate the fair value of options on the date they are granted, considering all factors known at the date of grant. Stock price changes after the grant date, either up or down, are not considered part of compensation expense. Employees who hold stock options are considered equity holders, like other stockholders, so changes in the value of the stock would not affect how much compensation is reported.

*Aren't Option-pricing Models Only an Arbitrary or Inaccurate Assessment of the Value of Stock Options?*

Option-pricing models estimate the exchange price of a stock option based on today's information. They do not attempt to predict the possible gain on exercise of a stock option. Option-pricing methods are at the heart of many transactions in today's financial markets. Option traders and companies that use strategies to hedge certain risks often employ methods similar to the option-pricing models described in the Board's Exposure Draft. Option-pricing models are reasonable estimates of fair value and also are used by compensation professionals to assist companies in determining the levels and forms of compensation to pay employees, including the number of options to be granted to individual employees. Employee stock options are different from traded stock options and we have made adjustments to the estimate of fair value for those differences, including nontransferability, vesting requirements, and longer terms.

Option-pricing models require estimates and judgments, as do most accounting measurements, including those for depreciation, pensions, and retiree health care benefits. Accountants should not ignore a transaction simply because it is difficult to measure. Determining a reasonable estimate of the value of the compensation is better than acting as if nothing has been paid. Zero clearly is not the right answer.

Why Not Just Improve the Disclosures About Stock Compensation? Shouldn't We Let the New SEC Proxy Disclosures Work for a While?

The current accounting is not credible and disclosures alone cannot cure bad accounting. If disclosure is an adequate substitute for recording a transaction, why not just disclose, for example, depreciation or salary expense or any other expense a company doesn't want to include in reported earnings? Why are the costs associated with stock options different?

The availability of relevant and reliable financial information is essential to our capital market system. If we tolerate inadequate financial reporting standards, we risk losing the confidence of investors and creditors.

The SEC's proxy rules require disclosures about executive compensation and the five most highly paid executives and do not address the financial reporting issues of stock-based compensation paid to all employees. Furthermore, the SEC rules do not apply to the many private companies that issue stock options. The Board believes that the users of financial statements are best served by recognizing all costs of employee services used by a company.

The Exposure Draft would require recognition of the cost of employee stock options prospectively to grants made after December 31, 1996. This will give companies time to rethink their compensation programs and time to work with option pricing methods. During that time, from 1994 to 1996, improved footnote disclosures, including the income statement and earnings-per-share effects, would be made.

*Isn't the FASB Just Responding to Political Pressure Regarding Excessive Executive Compensation?*

The Board is addressing the accounting for stock compensation solely because of the anomalous results that occur under the present accounting literature. We added

the project to our agenda in 1984 at the request of the AICPA and other constituents because of the problems with the current accounting, not for political reasons.

The Board is concerned with the accounting for all types of stock-based compensation, not with the level of executive pay.

*Didn't Congress Overrule the FASB on Oil and Gas Accounting in the Mid-70s Without Significant Effects on the Structure for Establishing Financial Accounting Standards?*

In fact, Congress has never overruled the FASB. In Public Law 94–163, "Energy Policy and Conservation Act," (December 1975) Congress looked to the FASB to establish standards for oil and gas accounting within 24 months. After the FASB issued a standard in late 1977, the SEC, in its oversight role, held hearings and eventually decided that in addition to the "successful efforts" method prescribed by the FASB, an alternative, "full cost accounting" would be permitted. This, in effect, gave companies the choice of which method to use. The FASB, with encouragement from the SEC, developed comprehensive disclosures for oil and gas producing activities, which were issued in 1982. The SEC's action to allow an alternative accounting treatment was unfortunate in our view, but it certainly was very different from Congress directly legislating accounting principles.

Some say that employee stock ownership and the issuance of employee stock options are activities that should be encouraged. Hiding the costs of those activities through accounting standards, however, should not be the tool for encouraging their use. The neutral reporting of the effects of transactions is critical to our system of financial reporting so that financial statements can be used to make the best economic decisions.

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## TESTIMONY OF MICHAEL W. BROWN

Vice President, Finance and Treasurer, Microsoft Corporation

on behalf of

The NASDAQ Stock Market

Chairman Dodd and Members of the subcommittee, I appreciate the opportunity to testify before the Subcommittee on Securities on behalf of the NASDAQ Stock Market. The NASDAQ Stock Market, the second largest in the world, is a computer screen-based market that operates, unlike an exchange, without a trading floor. Its network of competing market makers are linked together electronically by central computers located in Trumbull, Connecticut. It lists the securities of 4,300 domestic and foreign companies, more than all other U.S. stock markets combined. Its share volume has increased by more than 400 percent in the last ten years, and it now accounts for approximately 45% of all the equity share volume that takes place in the U.S. each day.

While the companies listing their securities on NASDAQ run the full spectrum of U.S. industries—more than 100 NASDAQ companies are larger than a billion dollars—they are best known for their high concentration in the newest and fastest growing industries, such as the telecommunications, biotechnology, environmental services, and computer and data processing industries, where most of the Nation's growth in jobs has come in recent years.

I am Microsoft's Vice President of Finance and Treasurer. I am responsible for the preparation of Microsoft's financial statements in accordance with the rules of the Securities and Exchange Commission and those accounting principles determined by the Financial Accounting Standards Board (FASB) to have general acceptance. I have practiced before the SEC and worked with the FASB for over 20 years as both a corporate financial officer and partner in a public accounting firm.

I am speaking today in opposition to the FASB's proposed accounting for stock options. Currently stock options are important to Microsoft and many other NASDAQ companies. They encourage new jobs and competitiveness and are good for both employees and shareholders. The FASB's new rule will discourage the use of stock options and employee ownership of American companies, especially for small high technology companies.

There are a variety of stock option plans today. Under current rules some result in compensation charges while others do not. The FASB's new rule is unnecessarily extreme, mandating a compensation charge for virtually any form of stock option that is likely to be issued.

IMPORTANCE OF OPTIONS TO MICROSOFT AND OTHER NASDAQ COMPANIES

Microsoft was founded in 1975. We develop, market, and support a wide range of software for computers, primarily smaller computers known as personal computers or "PCs." By making it easier to use personal computers for an increasing number of purposes, Microsoft products have contributed to the "PC revolution" during the last decade. The number of people who use personal computers has increased from one million in 1980 to more than 120 million today. Microsoft has grown to $3.7 billion in sales and today sells "American made" software in most countries of the world. As an international company with less than half of its revenues attributable to U.S. sales, Microsoft still employs over two-thirds of its 14,600 people in the United States.

Unlike some companies, which use stock options only to compensate a few highly paid executives, all of Microsoft's employees, from those on the production line to those in the development laboratory, are eligible to become shareholders in the company through its stock option program, and over 80% of today's employees hold shares or options on shares of the Company's stock. Not just Microsoft, but many of NASDAQ's entrepreneurial technology companies have options programs with wide employee participation, including, to name just a few, Adaptec, Apple Computer, Borland International, Centigram Communications, Cirrus Logic, Lotus Development, Novell, Octel Communications, Quantum Corporation, Sigma Designs, Sun Microsystems, Silicon Valley Group, and VLSI Technology.

Microsoft's stock options are typical of those found in many high technology entrepreneurial companies. They enable purchase of the Company's stock at its fair market value on the date the option is granted. This right vests over four and a half years and extends for ten years. Any value of the option at grant based on the future value of the stock is speculative. No charge is recorded for the option at time of grant or during its vesting period, much as a new company would not record a charge against earnings for the future value of its founders' ideas at the time of incorporation.

Entrepreneurs may join existing companies or start new ones. Today these events, accounted for similarly, are not prejudiced by accounting rules. A corporate founder and the 100th employee to join an existing company with stock options both have a similar opportunity to be an owner. Under the FASB's new rule, however, they will be treated differently, although there is no distinction in substance. Some do argue in support of the FASB's new rule that the contribution of human capital by an inventive founder to a new company is more important than that of a resourceful employee on the shop floor. They argue that accounting should differentiate these. My own view is that this is not a matter for accounting to adjudicate.

Stock options facilitate new jobs. They enable startup companies to create new jobs by attracting employees willing to take a risk for future capital gains. They enable existing companies to reinvent themselves by adding entrepreneurial employees in the face of rapid change. This reinvention of American companies is both efficient and important, not just in the executive suite, but in the laboratory and on the shop floor as well.

Stock options enhance American competitiveness. They enable cash salaries to be set at cost-conscious levels. If an employee-owned business experiences a downturn, frugality is already in place. If business prospers, shareholders and employees are rewarded together.

Stock options are good for shareholders. Cash investors risk financial capital. Employees risk human capital. The fortunes of the company's employees and shareholders are inexorably linked. They share risks and opportunities. They win or lose together. This partnership of financial and human capital provides the basis of America's entrepreneurial greatness, unmatched anywhere in the world.

While the new FASB rule will be bad for competitiveness, bad for jobs, bad for employees, and bad for shareholders, the new rule will be a tragedy, not so much for the Microsofts of this country that were once small, but have grown large, but for the little companies today being started and for the next generation of new technology companies necessary to create jobs and maintain competitiveness in the United States. Many don't or won't have the resources for lawyers, accountants, capital structure experts, and stock option consultants. In these young companies, employees are and will be at work on ideas for our future. Their work keeps them from being here to raise their voices against this FASB proposal, but the FASB proposal puts their work at risk. Without reasonable stock option accounting, the choice for many of them will be to return to the model of the American worker as just an employee, not an owner. This is the greater tragedy the FASB has promised us in the name of accounting theory.

## Lessons From Accounting's Past

There are today a variety of stock option arrangements available, some of which result in compensation charges in the income statement, and some of which do not. As a practical matter, the FASB's new rule—that there is virtually no conceivable form of stock option likely to be issued that does not result in a charge to the income statement—seems extreme. Such an extreme rule can only logically follow from the premise that employees must be only wage earners, and that capital appreciation can only accrue to financial, not human investments.

The FASB's new rule involves a form of endless loop accounting, where charges related to stock price changes are recorded in the income statement, magnified many times by future earnings multiples. Investors make investment decisions based on the income statement, a stewardship measure of management's performance. These investment decisions are then reflected in a company's stock price. If gains or charges based on stock prices are in turn recorded in the income statement, an endless loop results. Because stock prices often trade at a multiple of earnings based on a company's anticipated growth rates, a relatively small change in stock value may create a huge gain or charge in the income statement. For reasons of both the endless loop and the magnifying effect of multiples it was for a long time an honored accounting tradition that gains and charges on transactions in a company's own stock should not be recorded in its income statement. History serves to illustrate the wisdom of this caution.

In the 1920's, a popular practice was to capitalize the "value" of intercompany stock dividends, thus inflating earnings based on stock prices. Highly regarded early accountants and economists of the era like George O. May and Victor Canning spoke out strongly against this endless loop accounting, attributing a portion of the blame for the Crash of 1929 to these accounting abuses. Ironically, it may be argued that the SEC and its early framework of today's accounting standard setting were born in response, at least partially, to a variant of the same type of accounting today proposed by the FASB.

In 1984, an earlier FASB proposal on stock option accounting suggested a reverse form of the 1920's endless loop, one in which increasing stock prices would result in charges in the income statement rather than the gains of the 1920's. In this proposal, gains or charges were to occur whenever the stock price changed, with increasing stock prices resulting in charges and declining stock prices resulting in gains. Proforma application of this proposal to companies with stock option programs in place on Black Monday in 1987 highlights the counterintuitive nature of such accounting. Those companies with traditional option plans that suffered the greatest losses in stock value would have recorded the most significant gains. Fortunately, this proposal was abandoned.

The FASB's new rule would also result in charges to earnings based, in essence, on speculation about future earnings performance and stock prices. Assets which would result from the new rule in American balance sheets would also be subject to random charges in future financial statements should volatile stock prices decline. This occurs because FASB's new rule continues to involve half of the old endless loop. Under the new rule, charges associated with increasing stock prices would be recorded in the income statement, but not gains resulting from stock price declines. For traditional stock options granted at fair market value that are in wide use today, these charges would be recorded based on a valuation model. When stock prices have increased historically, an asset would actually be created that would then be amortized over the vesting period of the options. If the stock price should subsequently fall below historical rates before the asset is fully amortized, tradition and the SEC require that the impaired asset be written off, resulting in an unusual charge against earnings. The probability of a significant decline in the price of a volatile stock is reasonably high, so this is not an unlikely scenario. Microsoft's stock price, for example, has varied as much as 25% during the last six months. Many other NASDAQ companies, including Apple Computer, Novell, and Sun Microsystems have experienced similar fluctuations. The income statement charge that will necessarily follow a stock decline will represent writing off an asset that was recorded based on a speculative future stock price which did not occur. This will be difficult to explain, is not logical, and will be embarrassing for the accounting profession when it occurs.

Full disclosure has long been an important accounting tradition where speculative matters are involved. Full disclosure of compensation and stock arrangements for executives as currently required in proxy statements has already served to expose executive pay abuses and will continue to bring other instances to the attention of the public and shareholders.

I believe that full disclosure is up to the task of exposing executive pay abuses, invoking public outcry, and causing remedial response by corporate boards. Going beyond disclosure to the extreme rules promised by the FASB, however, and ignoring the lessons of history on the pitfalls of experiments with endless loop accounting is not warranted by present facts and circumstances.

### Accounting Standard Setting and Oversight by the Securities and Exchange Commission

It is fair to ask, why come to Congress with an accounting issue?

In 1933, after the Great Depression, Congress, in its wisdom, created the SEC and granted it authority to make accounting rules for companies that sell securities. Carmen Blough, the Commission's first chief accountant wisely opined that the accounting rules used by registrants should be those with "general acceptance," hence today's "generally accepted accounting principles," or "GAAP."

Under the thoughtful and responsible regulation of the SEC, the United States has developed the finest capital market in the world.

Although mindful of its statutory responsibilities, the SEC has generally allowed private sector organizations to establish most actual accounting standards. In 1962, however, the Accounting Principles Board (APB), the predecessor to today's FASB, ruled in its Opinion No. 2, that a particular method of accounting for tax credits was unacceptable. In Accounting Series Release No. 96, the SEC, in the interest of public policy, permitted such accounting for its registrants, the APB rule notwithstanding. The APB's rule was subsequently rescinded. Today tax credits still play an invigorating role in the American economy and the SEC's methodology is still in use.

The FASB succeeded the APB with an acknowledgment of the importance of public policy and an emphasis on general acceptance. Exposure drafts of statements were to be circulated widely to assure that proposed new rules met the test of general acceptance. The FASB's first Chairman, Marshall Armstrong, said in 1973, "Our pronouncements must neither encourage or discourage investment—neither encourage nor discourage growth."[1]

But today, on its new stock option rule, the FASB has received over 450 letters, most of these overwhelmingly opposed. Yet the Board's members have stated publicly that they will proceed with their proposal, apparently regardless of the outcome of the exposure period dialogue. From conversations with members of the Board, it is also my personal belief that the FASB is not receptive to further dialogue, testimony, or discussion. I believe a reemphasis of the principle of general acceptance is now warranted.

As a life long proponent of private sector accounting standard setting, I would prefer the forum of debate for accounting practices be the FASB, with recourse to the SEC. But the apparent inflexibility of the FASB places the SEC in a difficult position and demands the attention of the American people. I therefore applaud this hearing as a forum for expression of the public's views, as general acceptance is the necessary cornerstone of "generally accepted accounting principles." Moreover, Microsoft and NASDAQ are supportive of the stock option accounting provisions of Senator Lieberman's bill, "Equity Expansion Act of 1993" (S. 1175), as an expression of the absence of general acceptance of the FASB's new stock option rule.

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## TESTIMONY OF JAMES R. BUNT

Vice President and Comptroller, General Electric Company

on behalf of

The Financial Executives Institute

I appreciate this opportunity to testify before the Securities Subcommittee on behalf of the Financial Executives Institute. The FEI is an organization of 14,000 senior financial executives representing some 8,000 corporations who prepare and use financial statements. Over the 62 years of its existence, FEI and its members have contributed to the excellence of accounting standards now used in the United States.

[1] *The CPA Journal*, September 1973, excerpting an address by Marshall Armstrong, Chairman of the FASB, before the *Financial World* Conference on Corporate Financial Communications, New York, June 27, 1973.

You have asked us to comment on the merits of the accounting principles and concepts upon which the FASB's proposal is based. The following discussion addresses this highly complex and technical subject.

There is unprecedented opposition to the FASB's proposal. All of the major accounting firms, the largest shareholder advocacy groups, compensation consultants and other business and government leaders oppose the proposal. Many financial statement users would prefer expanded disclosures to facilitate their own analyses rather than a new accounting standard that cannot produce relevant results.

The anomalies that will result from the FASB's proposal demand a change in direction. We are deeply concerned about the adverse impact the proposed accounting is likely to have on U.S. competitiveness and job growth, especially with regard to small and high-technology companies. Employee stock options have played a powerful role in the creation and growth of many U.S. companies. In today's intensely competitive and global economy, we must look beyond the theoretical accounting aspects of this controversial issue.

### Is Current Accounting Misleading?

The FASB has asserted that current accounting is materially misleading. In paragraph 68, page 24, of the Exposure Draft the FASB states: Useful comparisons between entities of profit margins, rates of return, income from operations and the like were impossible.

In the introductory summary, they also state that existing accounting produces financial statements that are neither credible nor representationally faithful.

The FASB would have us believe that since the Accounting Principles Board adopted Opinion No. 25 in 1972—a 20-year period—the financial position and results of operations of companies with stock option plans have been misrepresented, yet only they have identified these errors. I can assert that during the past 20 years, not one share owner, securities analyst, nor member of the business press, has ever suggested that my Company's financial statements are flawed or misleading as a result of our accounting for employee stock options.

### Fair Value as the Basic Measurement Method

The FASB's proposal would require fair value as the basic method for measuring awards of employee stock options. Fair value of employee stock options issued by public entities would be estimated using an option-pricing model.

Concerns regarding valuation stem from one indisputable fact—today, there is *no* option pricing model that takes into account the numerous restrictions commonly found in long-term employee stock options. As a result, judgmental adjustments have to be made to virtually all valuations of employee stock options derived from current pricing models. This raises serious issues with respect to the reliability of using these fair value estimates as the basis for recording assets and their subsequent amortization as expense in the financial statements. It is also important to note that the valuation models can never be validated by subsequent events because there is no marketplace that provides an independent measure of value. Unlike some accounting that similarly is never validated, such as some one-off exchanges of nonmonetary assets, the meaninglessness of accounting for recurring stock option grants is a legacy that will not diminish in subsequent financial statements.

The FASB acknowledges option pricing models overvalue employee stock options because they do not take into account restrictions such as vesting requirements, nontransferability, performance conditions and limited "window" periods during which certain officers can exercise their stock options due to requirements of Section 16 of the Securities Exchange Act of 1934. The FASB has tried to compensate for these shortcomings by providing for adjustments to option values for the outcome of service- and performance-related conditions and the actual lives of options. However, these adaptations are incomplete, untested and unproven. Such adjustments are judgmental, add significant complexity to an already complex issue and can result in counterintuitive charges to expense. These issues are addressed in the Adjustments of Initial Estimates section below.

The use of option pricing models for employee stock options also requires enormous judgment. While FASB has not prescribed a specific pricing model, whatever model is used must take into account the exercise price and expected term of the option, the current price of the underlying stock, its expected volatility, the expected dividend yield on the stock, and the risk-free interest rate during the expected term of the option. Of these factors, only the exercise price, the current price of the underlying stock, and the risk-free interest rate for the expected option term are known at the grant date—the date the fair value is estimated. The other factors must be determined with a high degree of subjective judgment. For example, with

regard to volatility, management will have to decide how to calculate it, what past experience is relevant, whether significant nonrecurring events should be excluded, and then what rate of volatility should be used for the future which, of course, will differ from past experience. Based on experience to date with the pricing models, managements will be able to support a wide range of valuations. This raises further doubts that the valuation of employee stock options will be sufficiently reliable and comparable to justify using fair value estimates as the basis for recording expense in the financial statements.

Thus FEI believes it is necessary to advocate that stock options be viewed as compensatory only to the extent that they are "in the money" when granted.

Using my company as an example of why I believe this is the best accounting, note that GE employees who hold options share, along with approximately 500,000 GE share owners, the economic rewards of a market that has rewarded those share owners with an increase in wealth of over $50 billion in the last decade.

GE share owners' objective in approving option plans is to align employee interests with share owner interests. Many, in fact, believe that the grant of options is a transaction between share owners and employees, having no accounting consequence for the enterprise. Stock options are the most cost effective way of achieving that alignment irrespective of how these options are accounted for. The congruent interests of share owners and option holders should be presented with congruent accounting, that is, increases in share owner wealth are external to the financial statements. That answer is not difficult to support, and, in fact, all alternatives identified to date introduce noise and confusion into the already noisy communication of financial position and results of operations.

## Black-Scholes and Binomial Models

The Black-Scholes and binomial option pricing models are two models mentioned in the proposed statement. These models were developed for valuing freely-traded options with relatively short lives and are based on complex mathematical formulas. Option values derived under these models are highly sensitive to both the expected stock volatility and the expected dividend yield.

Stocks with a high volatility provide option holders with greater economic "up-side" potential and, accordingly, result in higher option values under the Black-Scholes and binomial option pricing models. Of course, high volatility also provides option holders with greater economic "down-side." Traders value volatility; employees do not.

The relative impact of changes in expected volatility and dividend rates on estimated option value using a generalized Black-Scholes option pricing model and a binomial pricing model are shown below. The relative sensitivity of these changes between the models is shown also.

## Estimated Option Values

*Assume:*

Exercise price—$100 (equals current price of underlying stock)
Expected dividends—0, 3%, and 6%
Expected risk-free rate of return—7%
Expected volatility—0, 20%, 40%, and 60%
Expected term—ten years

| Dividend Rate | | Volatility 0 | 20% | 40% | 60% |
|---|---|---|---|---|---|
| 0 | Black-Scholes | $49.17 | $52.34 | $64.40 | $76.33 |
| | Binomial | 49.17 | 52.34 | 64.40 | 76.33 |
| 3% | Black-Scholes | 23.57 | 29.94 | 42.55 | 53.54 |
| | Binomial | 23.57 | 30.20 | 45.28 | 58.90 |
| 6% | Black-Scholes | 5.00 | 15.88 | 27.79 | 37.59 |
| | Binomial | 5.00 | 18.40 | 34.55 | 48.08 |

In general, option value increases as expected volatility increases, and option value decreases as expected dividend yield increases. It is also interesting to note that in instances where higher expected volatility is coupled with higher dividend yields, the binomial model generally produces higher option values than the Black-

Scholes model (given the parameters of this specific example). Nevertheless, the proposed statement permits the use of either class of model.

In addition to the significant judgment involved in establishing variables required by the pricing models, judgments as to which model to use would also be required. This free choice of model may significantly affect the level of compensation cost ultimately recognized and the reliability and comparability of this data.

### Recognition of a Compensation Asset and Additional Equity

Under the FASB's proposal, companies would record at the grant date the estimated fair value of the award as a prepaid compensation asset and a corresponding increase in share owners' equity—Options Outstanding. The FASB supports this accounting by stating that it is consistent with current accounting for prepaid expenses.

We disagree.

The immediate increase in share owners' equity is at best misleading. The granting of an employee stock option does not create additional resources for the firm. Even if one accepts the FASB's valuation method, the fair value determined is simply a quantification of the expense to be recognized in future periods.

This "phantom equity" will disappear as a company amortizes its prepaid compensation asset to earnings, generally during the option vesting period. We believe this accounting method will render equity, the standard measure of worth and common basis for measuring investor return, meaningless. Clearly, this is bad accounting.

### Recognition of Tax Attributes

The tax effects that would be reported under FASB's proposal are, at best, contrived.

The prepaid compensation asset referred to above generally would result in a temporary difference, as defined by FASB Statement 109, "Accounting for Income Taxes," because the asset recognized for financial reporting would not result in tax deductions for the employer as it is amortized to expense.

Thus, under FASB's proposal, at the grant date a deferred tax liability would be recognized equal to the company's tax rate times the amount of the prepaid compensation asset. This deferred tax liability would be amortized, consistent with the prepaid compensation asset, resulting in a credit to the employer's financial statement income.

Despite the fact that this accounting is in accordance with the requirements of Statement 109, it is misleading in several ways.

First, the recognition of a deferred tax liability is solely a consequence of recognizing a prepaid compensation asset for the estimated fair value of an award which, as explained above, lacks any "rational" basis.

Second, when an employee exercises a stock option, the employer, under present tax law, receives a tax deduction equal to the gain realized by the employee—generally the difference between the exercise price and the market price of the underlying stock times the number of shares acquired. A tax deduction is realized by the employer only when and if the option is exercised; the tax effect of this deduction is recorded directly to share owners' equity and does not affect earnings. Neither the fair value of the award estimated at the grant date nor the deferred tax *liability* recognized at that time has any bearing on the amount of the tax deduction. Thus, the FASB's proposed accounting establishes a peculiar technique for reducing the expense of the options, but treats the tax event solely as a capital transaction.

### Adjustment of Initial Estimates

The estimation of the value of stock options at grant date requires estimates relative to the outcome of service- and performance-related conditions and the expected lives of options. Under the FASB's proposal, the estimated option value, and resulting compensation cost, would be adjusted for subsequent changes in the expected or actual outcome of these factors, although subsequent adjustments would not be made based on changed volatility, dividend yield, and interest rate assumptions.

For stock options, the estimated fair value at grant date would be adjusted for the actual option term. When the actual option term exceeds the term estimated at grant date, additional compensation cost would be recognized because options with longer exercise periods have greater value. For example, a decrease in the stock price to a point at which the option expires unexercised would result in additional compensation cost if a shorter option period was anticipated at grant date—bad accounting. It is important to note that expiration of an option would not avoid rec-

ognition of compensation cost. Only options forfeited because of failure to meet vesting requirements would be excluded from determination of compensation cost.

A performance requirement adds another condition that must be met in order to vest in certain awards, in addition to rendering services over a period of years. Although the forfeiture rate relative to employee termination may be subject to reasonably accurate estimation at the grant date, forfeiture rates resulting from failure to meet performance conditions—typically are not readily determinable.

### Transition

Since it is unlikely companies will adopt the expense recognition provisions of the proposed statement before 1997, most companies will face an increasing charge to earnings in future years because they would then be precluded from applying the expense recognition provisions to awards made prior to 1997. For example, assume a company awards stock options in 1997 valued at $4 million which results in $1 million of compensation expense each year during the company's 4-year vesting period. If awards with the same value and vesting schedule are made in 1998, the expense recognized in 1998 would be $2 million—$1 million from 1997 awards plus $1 million from 1998 awards—and so forth until the company reached a "normalized" rate. Thus, a company that would otherwise show level earnings during the period 1997 to 2001, would show declining earnings. Note the declining earnings would be reported along with increasing share owners' equity due to the recognition of prepaid compensation assets for the estimated fair value of the stock option awards. More bad accounting.

Assume:

| | |
|---|---|
| Options granted | 900 |
| Vesting schedule | 100% at end of third year (cliff vesting) |
| Estimated forfeiture rate | 5% per year (upon termination) |
| Actual forfeiture rate | 5% in years 1 and 2: 3% in year 3 |
| Estimated option value at grant date | $100 |

Estimated fair value of award at grant date:
(900 x .95 x .95 x .95) x $100 = $77,200

Compensation cost recognized in years 1 and 2:
$77,200/3 = $25,733

Compensation cost recognized in year 3
(3% forfeiture rate):

| | |
|---|---|
| Actual compensation cost to be recognized: | |
| (900 x .95 x .95 x .97) x $100 = | $78,800 |
| Cost recognized in year 1 | (25,733) |
| Cost recognized in year 2 | (25,733) |
| Cost recognized in year 3 | $27,334 |

### Summary

The preceding discussion indicates the great complexity and some of the anomalous results that we believe will occur if the FASB's proposed statement is adopted. FEI has serious concerns about the broad implications of the FASB's proposal.

In summary, we believe:

- Current accounting rules for stock option plans do not result in widespread misleading financial statements as suggested by the FASB.

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- FASB's proposal will not result in an improvement in financial reporting. The proposed accounting method is highly judgmental, unproven and does not result in the fair presentation of results of operations and financial position.
- There is unprecedented opposition to this project. Users have been universally strident in their opposition.
- FASB's proposal will have a significant adverse impact on U.S. competitiveness and job growth. Given the important role employee stock options have in the creation and growth of many U.S. companies and the intensely competitive global economy, public-policy issues should be considered.

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## TESTIMONY OF PROFESSOR MARY E. BARTH

CHAIR, FINANCIAL ACCOUNTING STANDARDS COMMITTEE
OF THE AMERICAN ACCOUNTING ASSOCIATION

Mr. Chairman, and Members of the subcommittee, thank you for inviting me to testify today on the subject of stock-based compensation. I represent the Financial Accounting Standards Committee of the American Accounting Association (AAA), which is a national professional organization of accountants. The Committee is the AAA Committee charged with responding to documents issued by standards-setters relating to financial reporting. In fulfilling that responsibility, the Committee responded to the Financial Accounting Standards Board (FASB) Exposure Draft, "Accounting for Stock-based Compensation." Our comment letter is attached. On behalf of the Committee, I am pleased to have the opportunity to share the Committee's views on this important topic. To summarize our comment letter, the Committee strongly supports the FASB's conclusions that stock-based compensation be recognized in financial statements as compensation expense.

The appropriateness of recognizing an expense for stock-based compensation is only one of the issues raised by the legislation you currently are considering. Two other issues that the Committee wishes to comment on are the potential effects of adopting the FASB proposal on American companies and their competitiveness, and the role of Congress in setting financial reporting standards. We have no comments with respect to the tax aspects of the legislation.

### EXPENSE RECOGNITION FOR STOCK-BASED COMPENSATION

The Committee believes strongly that stock options and other forms of stock-based awards to employees represent compensation and should be recognized as such. Such awards differ from other types of compensation only in form, not in substance. Under current accounting rules, an expense is recognized for most forms of employee compensation (including some forms of stock-based compensation such as variable stock plans), but is not for others (e.g., stock options whose exercise price equals the option price at the grant date). Implementation of the FASB's proposal would resolve the inconsistency among various forms of stock-based compensation and make the accounting for stock-based compensation consistent with that for other forms of employee compensation.

Recognizing compensation expense requires measuring it. Some have asserted that difficulties in measuring the value of stock-based compensation, particularly stock options, make recognition ill-advised. The Committee acknowledges that measurement issues exist. However, it does not believe that such issues are sufficiently insurmountable that recognizing zero expense is a better answer. Many accounting measurements already reflected in financial statements involve significant estimates (e.g., liabilities for pensions and post employment benefits other than pensions, loan losses, warranty accruals, and depreciation of fixed assets). Dealing with measurement issues is not new to financial reporting.

Methods for estimating the value of stock options granted are based on option-pricing theory. Although this theory may not be well understood by unsophisticated investors, it is the basis for a significant fraction of the transactions in our financial markets. The FASB recognizes that existing option-pricing models do not address explicitly employee stock options, and thus the models must be adjusted to accommodate employee options' peculiar aspects. The question is not whether this can be done perfectly, but whether it can be done sufficiently well to enhance the relevance and reliability of financial statements beyond the current measure of zero. The Committee believes that it can. The current standard for accounting for employee stock options was written over twenty years ago and before the Black-Scholes option pricing model was developed. The sophistication of our financial markets reflects the

technical advances in the options area since that time. It is time for financial reporting also to reflect those advances.

### EFFECTS ON AMERICAN COMPANIES AND THEIR COMPETITIVENESS

There have been a number of instances in the past when it had been asserted that a proposed financial reporting standard would harm the American economy in some way. The most recent example is accounting for postemployment benefits other than pensions. Others include expensing research and development and accounting for leases. The predicted devastating effects were not realized. Changing financial reporting standards does not change the economics of existing transactions, it only causes them to be reflected in the financial statements. Accordingly, the Committee is unconvinced that the adoption of the FASB's stock-based compensation proposal will have adverse effects on the competitiveness of American business.

A large body of research shows that our financial markets process publicly available information extremely efficiently. Thus, it is reasonable to assume that investors and creditors currently are assessing the effects on firms of stock-based compensation. To the extent that the recognized expense is in accord with such assessments, there will be no market effect. To the extent that the market is not knowledgeable about all aspects of the stock-based compensation and these aspects become better understood when the FASB's proposal is implemented, there may be market effects. However, even if the value of some firms decline on such disclosure one should not conclude that the disclosures will adversely affect American competitiveness. Efficient allocation of capital resources is critical to long run economic success, but efficient allocation cannot be obtained without adequate information. If resource allocation shifts upon availability of more information, it is reasonable to assume that the shift is toward efficiency, not away from it.

Stock-based compensation can be a very effective way to align the interests of employees with those of shareholders resulting in increased shareholder returns and efficiency. Encouraging the use of such plans may be a laudable government objective, but only when the plans are economically sound. Recognizing compensation expense related to such plans in no way negates the incentive benefits, it merely measures the cost. If the option structure of compensation is appropriate, the benefits will exceed the costs. To the extent the structure is inappropriate, adjusting it in response to the disclosure of the costs should improve its economic effectiveness.

### ROLE OF CONGRESS IN SETTING FINANCIAL REPORTING STANDARDS

The standard-setting process in the United States has resulted in arguably the best financial reporting system in the world. Although there is not always universal and complete agreement with the specifics of particular financial reporting standards, the system works well. The Committee is extremely concerned that the passage of this legislation, as it relates to financial reporting, will result in setting a precedent that could seriously undermine our current financial reporting system.

Financial reporting requires neutrality for credibility. FASB oversight by the Securities and Exchange Commission and Congressional committees can help assure the integrity of the system. However, neutrality will be compromised if special interest groups conclude that lobbying efforts, rather than reasoned arguments presented during the FASB's due process, can affect financial reporting standards.

The FASB's deliberative process is extensive, open, and inclusive. History shows that they—solicit advice from knowledgeable sources and often adjust their preliminary views based on input received before issuing a final standard. The process is not complete as regards accounting for stock-based compensation. We believe the FASB should be allowed to complete it without interference.

THE UNIVERSITY OF MICHIGAN
SCHOOL OF BUSINESS ADMINISTRATION
ANN ARBOR, MICHIGAN 48109-1234

Eugene A. Imhoff, Jr.
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September 3, 1993

Mr. Timothy S. Lucas
Financial Accounting Standards Board
File Reference No. 127-C
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Response to "Accounting for Stock-based Compensation"

Dear Mr. Lucas:

The Financial Accounting Standards Committee of the American Accounting Association is charged with responding to documents issued by standard-setters relating to financial reporting. The Financial Accounting Standards Committee has met and discussed the issues raised in the Exposure Draft "Accounting for Stock-based Compensation." This comment letter reflects those discussions. The opinions expressed in this comment letter reflect the views of individuals comprising the Committee and are not those of the American Accounting Association.

The ED identified ten issues related to stock-based compensation. These issues related to:

- Recognition of Compensation Cost
- Measurement Date
- Measurement Method
- Attribution Period
- Disclosures
- Effective Dates and Transition

The Committee agreed with the FASB's position on all ten issues, and in substance supports the recognition and measurement of stock-based compensation as soon as feasible.

While the Committee agreed with the views of the FASB on all issues, some lengthy discussion focused on the measurement date. The Board's position reflects its view of an equity issuance, and is internally consistent with that view. Some Committee members favored a liability point of view, which would result in several alternative effects:

- Grant date could be replaced with exercise date for the date of measurement.
- The actual costs recorded would equal the actual benefit received at the exercise date.
- The changes in the "cost" between grant date and exercise date could be accorded treatment as other changes in estimates.
- The uncertainty inherent in the measurement of cost at the date of grant (only) would be resolved by moving the ultimate measurement date to the exercise date.

We do not mean to suggest by the minority view noted above that the Committee was divided on whether to recognize and measure stock-based compensation. We are in complete agreement with the basic thrust of the ED, and would be unwilling to support further delays in the recording of stock-based compensation as a component of compensation expense.

The Committee appreciates the opportunity to participate in the Board's due process procedures and to have our views considered by the Board. We hope that our responses are helpful to the Board in its deliberations.

Sincerely,

Mary E. Barth, Chair
Timothy B. Bell
Daniel W. Collins
G. Michael Crooch
John A. Elliot
Thomas J. Frecka
Eugene A. Imhoff, Jr.
Wayne R. Landsman
Raymond G. Stephens

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## TESTIMONY OF DANE A. MILLER, PH.D. PRESIDENT AND CEO, BIOMET, INC.

on behalf of

THE ASSOCIATION OF PUBLICLY TRADED COMPANIES

Chairman Dodd and Members of the Subcommittee, I appreciate the opportunity to appear before you today. I am here on behalf of the Association of Publicly Traded Companies ("APTC") to describe an important American success story. I intend, of course, to emphasize the importance of employee stock options and the grave threat that the proposed FASB rule poses. However, if the question were broader—if it were "what made Biomet succeed?", I would still end up telling you about stock options. Stock options for employees are as much a part of the success of Biomet as research, design and export marketing, perhaps more so. Why? Because stock options are an essential element in our overall human resources strategy. Options create an essential ingredient in the success of a start-up or a growing company. They create *commitment.*

Biomet's stock option plan is key to attracting, motivating and keeping the *people* who make the company a success. Options make every Biomet employee a better worker because they represent an opportunity for that employee to share with our stockholders in the success of the company.

I have the honor to speak today for more than 400 member companies of the Association of Publicly Traded Companies and for the thousands of public companies the Association represents. APTC's membership is mostly smaller and mid-size companies. As you know, this highly productive sector of the economy has been responsible for much of the growth in jobs in recent years and is increasingly important in exporting U.S. products and services. The continued expansion of this sector of the economy is critical to our national prosperity. It is more important than deficit reduction, streamlining government or the North American Free Trade Agreement—each of which is very important. And I do not overstate the point to say that the broad availability of stock options is a *critical* issue for the small- and mid-size stock companies. It is critical to both those that are traded publicly and those "pre-public" companies, like Biomet fifteen years ago, when we set out to build a company to a point that its stock has value in the public markets.

### THE BIOMET STORY

Biomet is a manufacturing company located in the industrial heartland. We are also a high technology company, employing the latest materials and processes to make orthopedic devices like replacement hips and knees. Biomet is an example of what a manufacturing company needs to be as we approach the 21st century—nimble, international, export-minded and, above all, entrepreneurial. Options are the key to building and maintaining entrepreneurial culture. At Biomet, we don't use the term entrepreneurial in an individual sense. We think of entrepreneurial teams—everyone shares risks and everyone gets rewarded through options.

The four people who founded Biomet in 1977 each received a small salary and an early equity stake in the company. As a founder, I have never received an option for stock. Our option plan was established for everyone else. Top engineers and scientists were induced to move to exotic Warsaw, Indiana, take pay cuts, work 60 hours a week and commit to Biomet's success. Technicians and administrative employees joined the Biomet team with no pension, no health care and no profits and worked extraordinary hours because of the opportunity that our stock option plan presented.

In our first year we had sales of $17,000 and a net loss of $64,000. Now, after years of steady improvement, every fourth business day we generate federal tax revenues equal to the $500,000 SBA guaranteed loan that helped get us started. Currently Biomet employs 2000 people worldwide (1500 in the U.S.) and all of them receive options which are issued at market price on the date granted. Biomet team members all have the same stock in the stock plan as our shareholders.

Thanks to our team's hard work, Biomet has received the following awards and recognition for its growth and achievements: *The Wall Street Journal*—The Most Successful New Public Company in the 1980 Decade, 1990. *Forbes*—Best 200 Small Companies in America 1988 through 1992. *Business Week*—Largest 1000 Companies in the U.S., 1989 and named in Top 1000 of America's Most Valuable Companies in 1990, 1991 and 1992. *NAIC*—Growth Company of the Year in the U.S., 1988. *Duns Business Month*—Voted by their Board of Directors One of the Top Five Best Managed Companies in 1989. *United Shareholder Association*—Biomet on top 10 list of Companies Rated on Earnings, Executive Pay and Recognition of Shareholders

Rights—April 1991. Recipient of the *U.S. Small Business Administration's* National Entrepreneurial Success Award, 1991.

The Biomet story is not unique. APTC recently surveyed over 800 small- and mid-size companies and found that 60% of responding companies grant options to 100% of their employees. In the average company, 48%, almost half, of the stock options granted go to employees in the ranks of middle management and below. Companies give various reasons for options plans, but a few threads are apparent. Options attract the kind of exceptional talent that is essential to the success of an entrepreneurial enterprise; options help retain these same employees; they align the interests of shareholders and employees because a worker thinks, and works, differently when he or she is also an owner; and, especially for start-up companies, the use of options helps conserve precious capital for hiring more workers, doing better research and acquiring state-of-the-art equipment. (A copy of the APTC Survey is attached).

Options are a part of corporate strategy. They represent a decision by the boards of directors and shareholders that options produce a sense of ownership among employees. I dare say that those at the FASB who say an option is simply "compensation," a fee for service, have never started a business or left a secure situation to join an entrepreneurial venture. Options give an employee a stake in the company's success and a shot at wealth—more excitement, but certainly less security than they get from compensation for services.

Rather than compensation, options represent an assumption of risk and potential for reward. When Biomet began, new employees made an investment of time and talent in a venture that had less than a 10% chance of success. Our stock option plan said to new employees, "We are all in this together, every employee matters to our success and every employee will reap the rewards of success." We believe in options—and so do our shareholders—because an employee who sees his or her personal wealth tied to the fortunes of the company adds value to the company.

## The FASB Proposal

As to the merits of the FASB proposal on a strict accounting basis, I think it fails the basic test: whether the information it provides is more useful to investors than the information they currently receive. Certainly most investor groups have told FASB as much.

However, even before you ask that question, you have to look at FASB's basic assumption—that options are compensation like salary or bonus. It is wrong, at least for entrepreneurial companies. Compensation is paid for services and it is part of the employment relationship. Options are a motivational tool. We don't give options in exchange for services. We give options because we know they produce a *commitment* that comes from ownership of the company. Not every person wants to make that commitment; entrepreneurial culture is challenging and often stressful. A committed employee doesn't clock out and leave the job at 5:00 p.m., but only after the job is done. Options affect employees *attitudes*—toward their work, toward their supervisors and toward the company's investors. The entrepreneurial spirit at Biomet is built on the culture of options, not time-clocks and wages—and it works. Therefore, on this critical starting point upon which the whole FASB Stock Options Project rests, "options equal compensation," FASB is wrong. They simply fail to grasp the reality of entrepreneurial companies and the context of stock option plans.

If for argument's sake we concede that options are compensation, the FASB position only makes sense if the proposed charge to earnings provides more useful information than is currently available. I am no accountant but I have talked about this matter with accountants, analysts and corporate financial officers. There is a very strong consensus that this new information will confuse rather than clarify. So while this new rule will supposedly be added to the body of "generally accepted" accounting principles, there doesn't seem to be any acceptance, much less *general acceptance*. (Indeed, I know some chief financial officers are exploring the idea of producing a second, non-GAAP income statement that they believe will overcome the misleading information this new rule would mandate.)

Stock options grants are capital transactions—they affect stock. After all, a stock option is derivative of stock—not negotiable currency. When options plans are approved by shareholders, they accept the potential dilution of their claim to the company's earnings because they believe that options plans create commitment and commitment creates better earnings. Shareholders believe in making the pie bigger and sharing it with those who do the work.

FASB wants to impose a second charge to these shareholders by requiring companies to treat granting of stock options, in addition, as an income transaction. This effort is illogical since no payment from the company is required or ever will be.

FASB also wants us to conjure up an estimate of this expense that the company will never pay. That is the charge to earnings. This estimate will be a highly suspect number, of course.

According to the FASB, modern mathematics and computer programs have brought us to a point that we can accurately approximate option values. Paradoxically, the Black-Scholes model, selected by the FASB as the model for assigning a value to stock options, was in use for its intended purpose the last time the FASB decided that no model was accurate enough to use. The Black-Scholes model was designed for valuing traded options, not the long-term, long-vesting options that employees receive.

The Black-Scholes model may be better at predicting the value of a three-month stock option than any other known model; that no better model has been devised is reason unto itself for abandoning the effort to value options. Black-Scholes was not designed for predicting the value of long-term options and no one claims that it is accurate. Consequently, Black-Scholes values are inherently inaccurate and almost certainly misleading.

The Black-Scholes model is especially inaccurate for valuing options of small and medium capitalization companies because of the variable of stock price volatility or *"beta."* Black-Scholes was designed for valuing stock options that are actively traded, i.e., options on the stock of large companies with huge trading volume and low volatility. Furthermore, it was designed to estimate the value of a short-term option for a company with a significant history of dividends. Long-term options of small- and medium-sized companies are not the types of derivative securities that Black-Scholes was designed to value. Such companies tend to have higher volatility and little or no dividend history. The inaccuracy of a model that relies on two such unreliable factors (out of the six total variables) seems clear. It is even more inaccurate because the formula gives great weight to the volatility variable—higher volatility gives a higher value.

Further compounding these errors is the fact that the length of options that Black-Scholes was designed to value (months) is a small fraction of the length of the exercise period for the typical employee option (at least 2½ years). With these error factors compounding each other, it is clear that Black-Scholes valuation is inaccurate, irrelevant, and misleading for any *accounting* purpose. Therefore, the expense is not just a phantom expense, it is a highly misleading phantom expense—a dart-board toss in the dark.

Another distortion follows the phantom expense. This accounting phantom expense on the liability side requires a phantom asset on the other side of the ledger, supposedly representing the services purchased. Biomet and APTC Member companies do not *purchase services* with options; therefore, this looks to us like a "phony-baloney" asset. Furthermore, at least one analyst believes that this will create the opportunity to pump up a balance sheet with phony assets.

In sum, this is what will be "gained" from the FASB proposal: a highly suspect "value" for the options and a phantom asset, of equal value, to offset it.

Presently, on the income statement, the "value" of stock options is zero. Investors who think that the company gives compensation when it grants stock options can look at that "number," zero, and conclude that a number greater than zero should be there. It may not be accurate, but they at least know that they should adjust the net earnings figure downward. Under the FASB proposal, the "value" for options that appears as a cost will be a number larger than zero. It could be a huge number for a company with a broad options plan and a volatile stock. The investor, looking at that number, must then ask, "is that number high or low? Should I add to or subtract from the net earnings figure?" Most people think that zero is a better number. But regardless of what is the better number, if after all this work, FASB can do no better than this in terms of improving the accuracy of financial reporting, they had better go back to the drawing board.

## How Will Companies React

I have read the FASB's blithe prediction that companies will not cut back on stock option use even if they are required to reduce earnings. I don't see much to support that conclusion. The APTC survey shows that 63% of companies would reduce their grants of options. Moreover, the survey shows that they would reduce options availability to lower level employees. This is troubling, but it is only a rational response.

The same survey shows that, on average, only 15% of options go to CEOs. At Biomet, the top 2 executives receive *no* options. Cutting senior executive options doesn't get much savings. Significant savings on the options charge could be realized only by cutting into the 48% of options that go to employees at middle management and below in the average company. Companies also have to make rational decisions

about whose commitment matters the most. The executive, the engineer, the designer are certainly the critical employees. And incidentally, if the Congress—or the FASB—is concerned about the pay of American executives, let's get that issue honestly on the table. Clearly this accounting rule is the wrong way to address it. Roundabout solutions always do harm to unintended victims, like Biomet team members.

What will Biomet do about our options plan if the FASB goes forward? It's up to our Board and shareholders, of course; but my own view is, "tell me what my earnings will be next year and I will tell you whether or not we will have a choice."

APTC hopes that such choices will not be necessary because of the larger matter at stake here. Those of us who sit on the APTC Board work at companies that will survive if this new rule goes into effect—we are over the hump of profitability. But APTC endeavors to represent those companies that are not even close to profitability and will suffer a real, perhaps fatal blow if this rule goes into effect. What about the entrepreneur who doesn't even have the mythical "garage" yet? How will he or she start a company if options have to be booked as a cash expense? Believe me, in start-ups, the line between success and failure can be very thin. The jobs and the economic growth that the small- and medium-sized corporate sector can continue to produce are very much at stake in this debate. We would not be here otherwise.

## CONCLUSION

Thank you for this opportunity. On behalf of APTC, I would like to thank you, Senator Dodd, for scheduling this hearing. I would like to thank Senators Lieberman, Mack and Boxer for their leadership in this important effort. I would like to assure you that the millions of workers who have made the entrepreneurial choice and the options commitment thank you as well.

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# Stock Option Plans

Results of a Survey
Conducted by

## The Association of Publicly Traded Companies

1101 Connecticut Avenue, NW
Suite 700
Washington, DC 20036

October 6, 1993
Phone: (202) 857-1114
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# APTC

## SURVEY ON STOCK OPTION PLANS OF SMALL AND MEDIUM-SIZED PUBLIC COMPANIES

PURPOSE: To assemble facts regarding the uses of employee stock option grants among publicly traded companies, especially those of small and medium size. To obtain quantitative data on the benefits of stock option plans to young companies and to obtain quantitative data on the impact that a requirement to charge earnings for the Black-Scholes value of stock options will have on the earnings of such companies. To supplement the data obtained by other surveys of options in somewhat larger companies by other organizations and industry-specific surveys conducted by other groups.

METHODOLOGY: Survey questions were aimed at obtaining information from a broad range of companies that use stock option plans. The survey also focused on small and medium-sized companies. Surveys were sent to 879 companies.

RESPONSE: 168 companies responded to the survey, a 19% return. Most companies which responded had stock options plans. Many had insufficient data to provide some of the quantitative information the survey sought because they lacked the facilities to compute model-based values for stock options granted to employees.

SURVEY RESULTS:

HIGHLIGHTS:

* The typical Options Plan distributes options widely and deeply throughout the company. 48% of options go to employees at the level of *middle management or lower*. 60% of options plans grant options to *all employees* of the company.

* Stock options link the interests of employees and shareholders. 97% of option plans use the current market price as the strike, or exercise, price of the option. Thus, the options have value only if the stock price goes up. Only 10% offer "in-the-money" or below market options.

* The average vesting period for options is from 2½ to 4½ years. Vested options need not be exercised for an average period of 8½ years.

* Options motivate employees to make a commitment to the company. Employees also take a risk – many options become worthless before they vest.

* Use of options in lieu of cash compensation gives companies extra cash to spend on hiring additional employees, research and development and capital equipment. Companies that estimated the quantitative benefit of options showed a per company average of:

  - $2,160,000 spent on hiring additional personnel ($84 million for 39 companies);
  - $1,524,000 spent on additional research and development ($41 million for 27 companies); and
  - $1,127,000 spent on additional capital equipment ($24.8 million for 22 companies).

* Implementation of the FASB decision to require a charge to earnings for options will cause companies to reduce the scope and depth of the options plans. In order to reduce the charge to earnings, companies will grant options to only top management and key personnel. The charge will deny options to lower level employees.

* 75% of responding companies disagree with the FASB methodology for valuing stock options.

* Stock options are part of entrepreneurial culture and of corporate strategy. Stock Option Plans are aimed at attracting key personnel, retaining experienced employees, linking the interests of shareholders and employees and motivating personnel to accept the unusual demands of a growing company.

### DATA OBTAINED FROM APTC SURVEY

Does your firm offer stock options to employees? YES: 98% NO: 2%

If your firm uses options, please identify the purpose(s) they fulfill in your overall corporate strategy:

92% attract key personnel
90% retain experienced employees
83% link employees' and shareholders' interests
77% motivate personnel to accept the unusual demands of a growing company

Company comments on other purposes:

"an owner thinks differently than an employee" - Biomet

"focus on longer term goals" - Apogee Enterprises

"conserve capital" - Aphton Corporation

"without an option plan, we would be unable to retain many key managers" - Capital Southwest

"alternative to Pension Plan - don't have one...without options, recruiting key personnel will be difficult if not impossible" - Deprenyl Animal Health

"incentive to all our store managers and salesmen to grow the business (profitably)" - O'Reilly Automotive

"make [employees] 'owners' of the company" - Insignia Systems

"offset higher compensation [elsewhere]" - Liberty Technologies

"attract qualified Board of Directors candidates" - Digital Biomedics

"pension/profit sharing" - Healthcare Services Group

"long term compensation to partially offset lack of a pension plan" - Glycomed

"to make all employees feel an ownership in the progress of the company" - Cytogen Corporation

"makes it possible for a smaller company like ours to compete with larger ones for key personnel" - Varsity Spirit

"increase employee's affiliation with the company" - Leslie's Poolmart

"compensate for the higher risk associated with working for a small company" - Biomagnetic Technologies

"reduce cash consumption early on" - Cardiovascular Imaging Systems

"reward for performance" - Executive TeleCard

"preserve cash/capital to pay for future R&D" - Agouron Pharmaceuticals

"encourage a long term commitment to company" - Aerodyne Products

"reduce operating costs" - Sports & Recreation

"offer compensation packages that attract top people which salary levels may not do" - Modatech Systems

"allow employees to share in the growth of the company" - Synopsys

"incentive - they have to make [the option] worth something" - Protocol Systems

"encourage a long term commitment to company" - Intec Industrial Technologies

"acquisitions, service providers to reduce cash outlay" - Paragon Mortgage

"move toward more 'incentive based' pay program for key employees" - CenFed Bank

"provide more long term compensation" - Sealright Company

"attract and retain good board members" - Prime Federal Bank

"serve to reduce cash compensation by substituting long term stock compensation" - State Bancorp

"purchase technology" - FSI International

"reward performance" - Huntington Bancshares

"substitute for cash compensation in some cases" - Harmony Brook

"reward key executives" - US Can Company

"increase capital of the company" - Sterling Financial Corporation

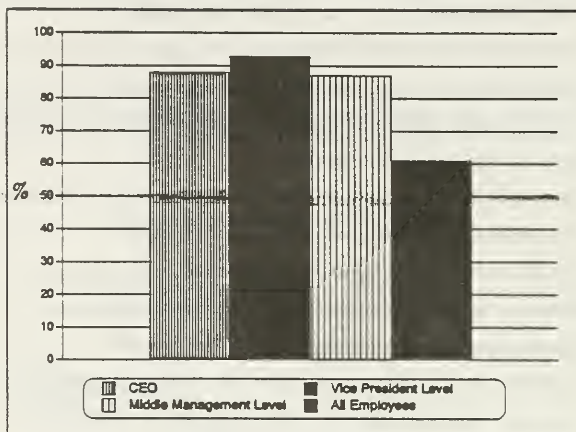
"supplement below market compensation for developing company" - IDEXX Laboratories

"in 1991, senior management agreed to forego annual salary increases in exchange for options as the company cash position/operating income was otherwise insufficient to service debt" - U.S. Paging Corporation

"allow [employees] to prosper for their work beyond a paycheck" - Digital Systems International

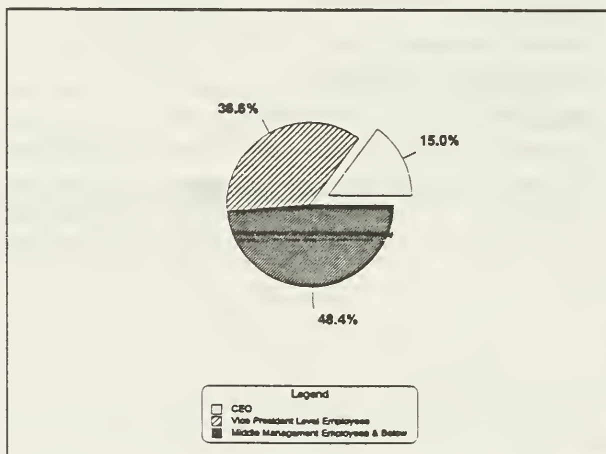
If your firm uses stock options, which of the following employee groups are eligible to receive stock options?

Key Finding: in 60% of respondents, all employees are eligible to receive options



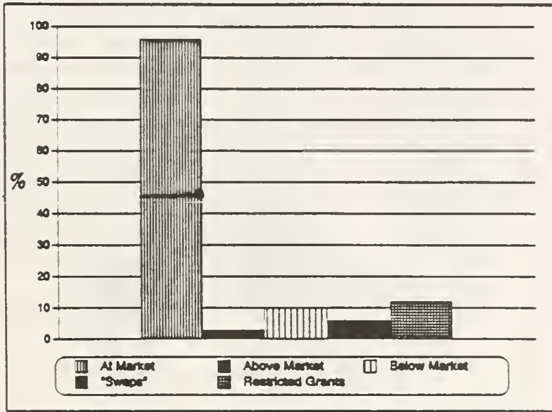

Over the past three years, what percentage of the stock options granted by your firm went to which employees?

Key Finding: 48% of options granted went to middle management and below and only 15% went to CEOs



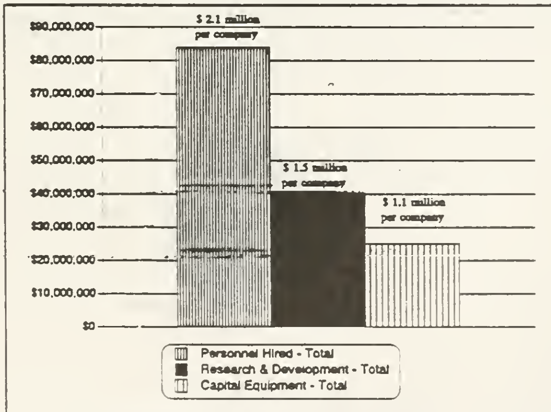
Which of the following variants of stock options does your company use?

Key Finding: 96% of all options granted were granted "at market" - these options are worthless unless the stock price rises



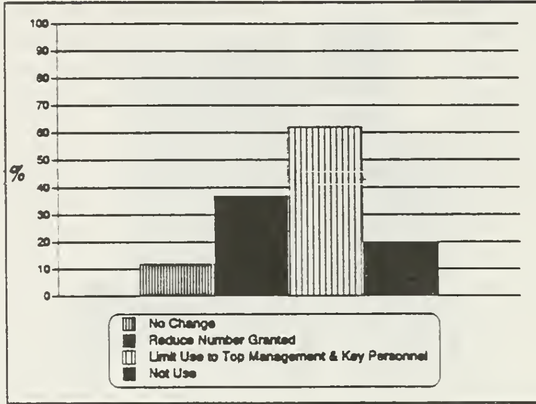

Please estimate the amount of cash your company was able to invest in the following categories as a result of cash compensation foregone in exchange for stock options?

Key Finding: Responding companies calculated an average additional investment of $2.1 million in personnel hired, $1.5 million in R&D and $1.1 million in capital equipment.



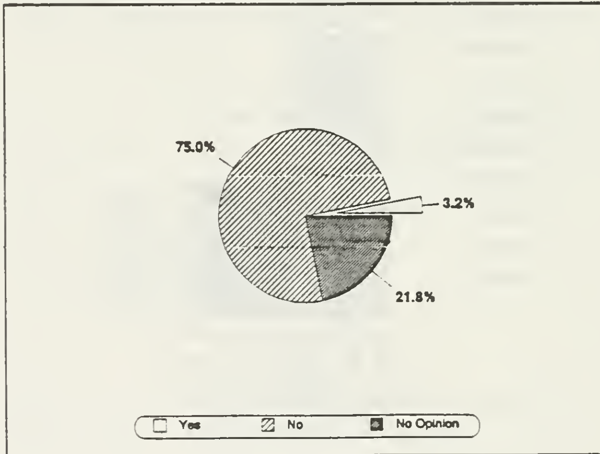
If FASB implements its decision to force a charge for options, how would this change your firm's options plan?

Key Finding: 63% of companies would limit their grant of options by restricting their availability to employees at the lower levels.

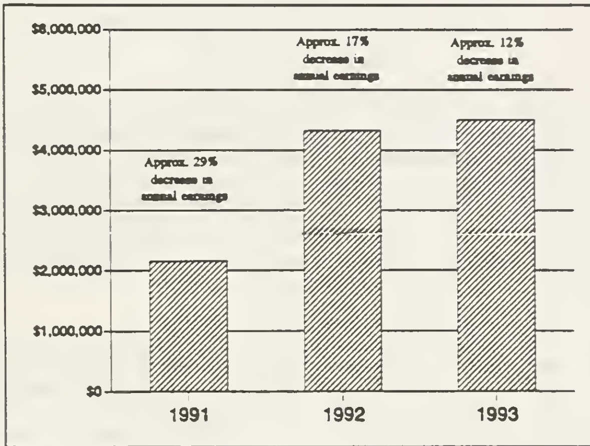



Do you agree with the FASB methodology for calculating the charge, ie., the present value of stock options when granted based on the Black-Scholes model?

Key Finding: Virtually every company that has an opinion objects to the valuation method favored by the FASB.



Have you calculated the potential impact of a charge for stock options on your earnings for any year? If so, please indicate below the percentage and/or amount of change in earnings.



# TESTIMONY OF JAMES P. MELICAN

EXECUTIVE VICE PRESIDENT, INTERNATIONAL PAPER

on behalf of

NATIONAL ASSOCIATION OF MANUFACTURERS

## EXECUTIVE SUMMARY

Stock options are used broadly throughout corporate America and are viewed as important tools for motivating and retaining employees. A 1992 survey of NAM members confirms this conclusion. 81 percent described stock options as either important or essential for attracting and retaining employees.

In the event FASB adopts its proposed standard, many companies will be forced to take a hard look at their current programs. The 1992 NAM survey referenced above also confirms this conclusion. When asked how they would react if the FASB proposal were adopted, four percent said they would eliminate stock options *altogether*, six percent indicated they would be forced to limit eligibility to senior management, and 42 percent of the respondents indicated they would be forced to reduce the number of employees eligible to participate.

Stripped of its arcane accounting rhetoric, the FASB proposal is a decidedly backward measure that will have real consequences for millions of working men and women. Many may well be deprived of an opportunity to have a concrete stake in the firms for whom they work and a chance to gain a modest but meaningful return by investing in the growth and vitality of America. At a time characterized by relatively slower real income growth and extremely low interest rates, elimination of these investment opportunities will be an unwelcome blow. Millions of investors, moreover, will face an economic Catch-22. Under the FASB proposal no one will gain, yet many will lose.

Congressional proponents of the FASB proposal continue to point to the debate over executive compensation as a justification for pursuing the accounting change. It is an exercise in obfuscation. Congress and the Securities and Exchange Commission (SEC) have already responded to concerns over executive pay by making significant policy changes.

There are those who compare accounting for stock options with the controversy over accounting for retiree health care benefits. The comparison fails on two counts. First, unlike the grant of a stock option, retiree health care costs were and are a real liability that results in the expenditure of resources. The second difference is that public policy considerations buttressed the change in accounting with regard to retiree health benefits but do not with respect to stock options.

Generally Accepted Accounting Principles (GAAP) must be firmly grounded on a foundation of consensus and acceptance. As the body charged with formulating accounting principles, FASB has failed to work toward consensus and obtain "general acceptance" of its stock option accounting proposal.

The future credibility and legitimacy of FASB and the private-sector standard-setting process demand that members of the Board and its constituencies resist political interference.

Mr. Chairman and Members of the subcommittee:

My name is Jim Melican and I am executive vice president of International Paper. I appear before you today in my capacity as Chairman of the National Association of Manufacturer's (NAM) Corporate Finance and Management Committee. Thank you for inviting me to testify. The NAM is a voluntary business association of more than 12,000 members, large and small, located in every state. Members range in size from the very large to the more than 9,000 smaller manufacturing firms, each with fewer than 500 employees. NAM members employ 85 percent of all workers in manufacturing and produce more than 80 percent of the nation's manufactured goods.

My testimony will focus on three issues. First, I will give a profile of how NAM members are using stock options to contribute to American economic and technological prowess. Second, I will address how the proposed accounting standard of the Financial Accounting Standards Board (FASB) threatens the present use—and growth in use—of stock options. And finally, I will make a few general observations about issues that have arisen during the debate over stock option accounting.

## I. STOCK OPTIONS ARE BROADLY USED AND THE TREND IS TOWARD BROADER USE

Stock options are used broadly throughout corporate America and are viewed as important tools for motivating and retaining employees. A 1992 survey of NAM

members confirms this conclusion. 81 percent of survey respondents described stock options as either important or essential for attracting and retaining employees. Surveys conducted by Share Data, Inc., the Association of Publicly Traded Companies (APTC), and Venture One all yielded similar results. In addition to survey evidence, my personal experience at International Paper and other anecdotal evidence demonstrates that the use of stock options is increasingly viewed as an essential contributor to business success.

I would like first to address a couple of misimpressions that I think exist in certain quarters, either that stock options are being used by company management to dilute shareholders' equity interests, or that they are reserved for the exclusive use of a small group of already well-compensated corporate executives. In the case I know best—International Paper—neither impression accords with the facts. First, assuming that all outstanding stock options held by IP employees were exercised tomorrow—not a good assumption since many of them are "under water"—the resultant shares would represent about two and one-half percent of the total shares outstanding. Second, the aggregate number of options held by the five top executives (as listed in the proxy statement) represents less than eight percent of the total employee options outstanding and just two-tenths of one percent of the total shares outstanding.

With regard to who is receiving stock options today, the fact is, there is an unmistakable trend among companies to go ever deeper into employee ranks in offering stock options. Allow me to sketch for you the profiles of three other NAM members and how they are using stock options to motivate and retain employees.

*General Mills.* In September 1993, General Mills instituted a new stock option plan under which *all* 120,000 employees are eligible to participate after three years of service. General Mills strongly believes that giving employees a stake in the company will contribute to its success. General Mills shareholders, by approving this exceedingly broad-based plan just last month, obviously believe it is in their best interests as well.

*NYNEX Corporation.* NYNEX Corporation adopted a broad-based stock option plan that resulted in the grant of options to *every* regular full- and part-time employee who was on the payroll on March 1, 1992. Top management was excluded from the program. The grant went to 75,000 employees, from fork lift operators to marketing managers, and resulted in over 51,000 non-management employees receiving a potential ownership slice of NYNEX. NYNEX believes that giving all employees a stake in the company will benefit consumers, shareholders, employees and the company as a whole.

*Pfizer Incorporated.* Pfizer is a pioneer in the broad use of stock options. The company has been granting stock options to its employees since the early 1950s. Pfizer's current program is open to *all* of its 18,000 U.S. employees. The average employee receives a grant of options every three years.

### II. FASB Proposal Will Curtail Stock Option Use and Halt the Trend Toward Broader Use

In the event FASB adopts its proposed standard, many companies will be forced to take a hard look at their current programs, and in many instances take responsive actions—including the possibility of eliminating stock options altogether, limiting them to senior management or curtailing further penetration into the ranks of lower-level employees. The 1992 NAM survey referenced above also confirms this conclusion. When asked how they would react if the FASB proposal were adopted, four percent said they would eliminate stock options *altogether,* six percent indicated they would be forced to limit eligibility to senior management, and 42 percent of the respondents indicated they would be forced to reduce the number of employees eligible to participate.

To the NAM membership generally, it seems ironic that political pressures generated by a few, well-publicized stories involving a handful of corporate executives would lead to such an anomalous result. Take, for example, the NYNEX program I mentioned earlier; it would encounter an immediate problem should the FASB proposal be adopted. Rather than an ongoing series of grants to individual employees, the March 1992 grant was a one-time grant to all 75,000 employees. The company has anticipated the possibility of a follow-up grant at some future point. Adoption of the FASB proposal would jeopardize that grant.

Stripped of its arcane accounting rhetoric, the FASB proposal is a decidedly backward measure that will have real consequences for millions of working men and women. The employees of the NAM member companies may well be deprived of an opportunity, in preparing for their retirement, to have a concrete stake in the firms for whom they work and a chance to gain a modest but meaningful return by invest-

ing in the growth and vitality of America. At a time characterized by relatively slower real income growth and extremely low interest rates, elimination of these investment opportunities will be an unwelcome blow. Millions of investors, moreover, will face an economic Catch-22. Do they cease voting in favor of stock plans because of their significantly greater impact on earnings and thereby lose the motivational effects such plans bring about, or do they continue to approve stock-based programs and suffer the share price consequences that will likely follow from the resulting depression of earnings? Either way, they lose.

## III. Additional Observations

### *A. The Executive Compensation Argument Has Become a Red Herring*

Congressional proponents of the FASB proposal continue to point to the publicity surrounding executive compensation as a justification for pursuing the accounting change. It is an exercise in obfuscation. Congress and the Securities and Exchange Commission (SEC) have already responded to public concerns over executive pay by making several significant policy charges. First, the SEC completely revamped its disclosure rules making compensation disclosure easier to understand, while at the same time, more comprehensive. Second, shareholders have been empowered to seek votes on executive compensation policy. And finally, Congress has now limited the tax deductibility of executive compensation. That new tax provision, moreover, makes continued deductibility dependent on obtaining specific shareholder approval of how many options can be awarded to any one individual, such as the chief executive officer, thereby rendering the process significantly more transparent. In light of all the policy changes adopted to date, there is no remaining public policy issue regarding the use of stock options as a vehicle for executive compensation.

### *B. Stock Option Issue is Not Analogous to the Retiree Health Benefits Issue*

There are those who compare accounting for stock options with the issue of retiree health care benefits, and the surrounding controversy accompanying adoption of that accounting standard. The comparison fails on two counts. First, unlike the grant of a stock option, retiree health care costs were and are a real liability that results in the expenditure of resources. FASB Concepts Statement No. 6 defines an expense as either an outflow of cash, using up of an asset or the incurring of a liability. The grant of a stock option at the market price, however, does not result in an outflow of cash from the corporate treasury, does not generate a liability and, should the option be exercised, results in a capital contribution from the proceeds derived from the sale of the stock. To most of us laymen, the argument that a grant of an option is an "expense," as the FASB contends, seems mind-boggling. If a transaction doesn't look, act or walk like an expense and there is no real or practical income statement consequence, characterizing stock option grants as "expenses" appears to be an exercise in sophistry.

The second difference between the two issues is that public policy considerations buttressed the change in retiree health benefits accounting but do not with respect to stock options. While undoubtedly there was considerable uproar surrounding the health benefits change, it can be argued that it has brought about more prudent financial practices in anticipating and preparing for future liabilities. Nothing of the sort can be claimed with regard to the present controversy. Indeed, sound public policy not only militates against the FASB proposal, but has been knowingly and intentionally excluded from FASB's deliberations.

### *C. Accounting Principles Must be Based on General Acceptance*

Generally Accepted Accounting Principles (GAAP) must be just that—generally accepted, in the sense of being firmly grounded on a foundation of consensus and acceptance. As the body charged with formulating accounting principles, FASB has failed to work toward consensus and certainly has not obtained "general acceptance" of its stock option accounting proposal. While many companies opposed the retiree health benefits change, there is a quantum difference between the grumbling then and the outright rejection and near universal opposition now. Every conceivable constituency of FASB—institutional investors, financial executives, accountants, regulators, and public companies—nearly unanimously oppose this change. To continue on and adopt the proposal without even a modicum of support from its constituencies would make a mockery of the concept of general acceptance.

### *D. FASB Must in the Future Resist Political Pressure*

Today's hearing is an indication that the private-sector standard-setting process has broken down, at least with regard to the stock option question. There is a broad consensus—which the NAM supports—that Congress should not intervene in the process of developing and improving financial accounting standards. With rare ex-

ception, that consensus has held since the creation of FASB in 1973. Regrettably, in our view FASB has allowed its processes to be wrongly directed and influenced by congressional pressure. While FASB claims the contrary, the record is clear that this project was reopened because legislation was introduced in the Senate. The politics and rhetoric surrounding executive compensation have wrongly influenced the members of FASB and have tainted the process.

The continued credibility and legitimacy of FASB and the private-sector standard-setting process demand that members of the Board and its constituencies act together to resist political interference. However, once stock option accounting became a political football, the constituencies that FASB chose to ignore have unfortunately had no other option but to make their case in the political bodies. It is therefore totally appropriate and necessary for Senators Lieberman and Bradley to step forward to provide a legislative counter-balance, while at the same time highlighting the important public policy interests put at risk by the FASB proposal. We commend both Senators for their leadership. Today's hearing is a welcome opportunity to move all concerned toward an outcome that can be generally accepted and that is grounded in sound public policy.

## Conclusion

To briefly recapitulate the NAM's position, stock options increasingly are favored tools for motivating and retaining employees. Once generally reserved for top management, there is today an unmistakable trend for eligibility to be extended deeper into employee ranks. The NAM member-companies we profile above offer stock options to *every* employee. Were it to be adopted, the FASB proposal would threaten the continued maintenance and growth of stock programs, potentially depriving millions of working men and women a chance to make a modest but meaningful return by investing in the growth and vitality of America. Shareholders, moreover, will be put in an economic Catch-22. Under the FASB proposal no one will gain, yet many will lose.

Thank you for your time and attention.

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## STATEMENT OF SENATOR CHRISTOPHER J. DODD

### Chairman, Subcommittee on Securities

Let me welcome everyone to our hearing on accounting for stock options—or should I say, our hearing on the Financial Accounting Standards Board Exposure Draft on Accounting for Stock-Based Compensation.

This is a highly technical subject, but it has major implications for employees, for stockholders, and for small and growing companies in our economy.

Stock options have been tremendously important in building companies, like MCI and Microsoft, which have created thousands of jobs and have become international competitors.

They have been essential in the development of the U.S. electronics industry, the biotech industry, and other high technology industries, where an entrepreneur has an idea, but little cash. Other risk-takers have been willing to join the company for a share of its future profits—if, in fact, there are profits in the future.

### Giving Workers A Stake In Their Companies

We tend to focus on the high technology industries, but we also should be aware of the employee stock option program of a company like Wendy's, where an assistant store manager can own a stake in his company—and a stake in our capitalist system. What other country in the world makes its workers owners to the extent we do in this country!

It is, and should be, our national policy to encourage share ownership by the largest possible group of our workforce.

So, this hearing today, while it is on a very arcane and technical subject, is vitally important to the American workforce, to shareholders, and to the economic growth of this country.

### The Issue Is Not Whether Stock Options Are Good Or Bad

I don't think there should be much disagreement about the value of employee stock options. Even the Financial Accounting Standards Board has pointed out that the issue is not whether employee stock options are good or bad, but how to account for them in corporate financial statements. FASB *[FAZ-BEE]* emphasizes that accounting standards should be "neutral."

Others have questioned whether the path FASB has chosen is, in fact, neutral. Companies who are testifying this morning have told us that the FASB proposal could have a serious negative impact on the ability of start-up companies to attract and retain employees, and on the willingness of more established companies to grant broad-based stock options to mid- and lower-level employees. They have said it will raise their cost of capital and that, in the end, it will affect their competitiveness and growth.

These companies, as well as some large shareholder groups, also make the point that, accounting is not a science, it is an art. There is room for judgment. They maintain that while FASB may have gone down a logical path to arrive at its proposal, there is an alternative, logical path that is not as disruptive.

I want to thank all of our witnesses for coming this morning—some from as far away as Washington State and California. Let me apologize to the second panel for the fact that we will have you elbow-to-elbow at the witness table. Dozens of companies and organizations have asked to testify. We turned down many more than we were able to accommodate.

I also look forward to hearing from FASB, whose vice chairman is with us this morning. FASB is a highly respected organization that plays an essential role in establishing generally accepted accounting principles.

### Colleagues Here Today

Let me also thank my colleagues who are taking the time to appear here this morning.

First of all, let me thank Carl Levin, who several years ago held hearings on the issue of executive pay. The attention Senator Levin focused on this issue helped bring about a change in policy at the SEC. The SEC now requires management to include in its proxy statements shareholder proposals relating to executive pay policies.

The SEC also requires better disclosure of executive pay. Now, shareholders can see clearly what top management is getting paid—both in cash and in stock options.

Let me also thank my colleague, the Senator from Connecticut, Joe Lieberman, who, more than anyone else I know, has focused attention on the needs of small businesses in the New England region.

He has worked tirelessly to battle the "Credit Crunch," he has worked to improve small business access to capital, and he has devoted a tremendous amount of time to the issue of stock options, which is so important for the small businesses of our State and the region. This is the first time he has appeared before this subcommittee, and I am very honored to have him here.

We have two other congressional witnesses, my friend Congresswoman Anna Eshoo from California, who has shown tremendous concern for the high tech community in her State, and the Senator from New Jersey, Senator Bradley, who for many years has focused attention on the special role of the high technology community in our economy. We are delighted to have them appear this morning.

### Role Of Congress

Before I close, let me address the concerns of those who question our having this hearing—who say Congress should stay out of the FASB process.

My strong view is that we should not move legislation in this area. I am not foreclosing it, but I hope we will not reach that point. However, I want to emphasize that Congress does have a responsibility to ensure that issues of public policy be aired.

The Financial Accounting Standards Board, in the end, should be accountable to someone. The SEC reviews the standards it proposes and determines whether they are appropriate for companies that file with the SEC. And, in the end, the SEC is accountable to the Congress and to this subcommittee in particular.

So, I would underscore the role we have here today. We are not "Politicizing," as some would suggest, the setting of accounting standards. We are reviewing a critical public policy issue.

I look forward to hearing from the witnesses, and thank all of you for coming.

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## STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I commend you for convening today's hearing to examine she FASB's recent proposal regarding employee stock options. The FASB's proposal is highly controversial since it would require companies that give employees stock options to report a charge against the company's earnings.

Employee stock options play an important role in corporate America. Stock options are particularly important to young, emerging growth companies. The use of stock options as compensation allows entrepreneurs and other risk-takers to form companies that provide valuable technology and services to our Nation.

Small, start-up companies frequently use stock options in order to compete in the labor market for talented and skilled employees. In turn, these companies can also provide a significant number of new jobs.

More "mature,'" well-established companies also use stock options as a means to motivate employees. Employee stock options allow employees the opportunity to have a stake in the performance of the company. Performance based stock options encourage employees to be more efficient and productive in order to increase the profitability of the company.

There have been certain abuses involving excessive executive compensation over the last several years, some of which were addressed in hearings conducted by Senator Levin in 1991. At one of these hearings, Senator Cohen pointed to the need for shareholders to have comprehensible information regarding compensation, "[s]hareholders want a bottom line so they can make an assessment of what is going on."

I would urge the FASB to work with the users of financial statements—the investors—to determine what information would be most useful to shareholders in getting to that bottom line. The FASB should consider carefully the consequences of their proposed change in accounting principles and work with the users and issuers of financial statements to disclose the use of employee stock options so that it is truly "generally accepted."

I look forward to hearing from today's distinguished panel of witnesses. Thank you, Mr. Chairman.

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## PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Mr. Chairman, I am very pleased that you have called this morning's hearing. I appreciate the opportunity to discuss the proposal by the Financial Accounting Standards Board that would require companies to take a charge to earnings for stock options awarded to employees.

Mr. Chairman, let me say from the outset that I believe the FASB proposal is wrong-headed and anti-competitive. Stock options have proved to be an excellent tool for start-up and emerging growth companies to attract skilled employees. Stock options transform workers from employees to owners. In providing workers a real stake in the future of the company through stock options, companies create a climate of dedication and enthusiasm that simple cash compensation cannot match. Presumably any "cost" to the company from providing stock options is more than offset in terms of increased productivity. I strongly believe that stock option plans are one of the important tools that increase U.S. competitiveness.

If FASB's rule were to go into effect, I do not believe that we would see any significant reduction in the compensation of the corporate superstars. Top executives will always be able to command top compensation. Where you will see an impact is on the companies with broad based stock option plans. Stock option accounting will be particularly detrimental to emerging growth companies, that have a larger percentage of their shares in stock option compensation.

I would prefer that Congress did not legislate accounting standards. The independence of the Financial Accounting Standards Board has served our economy well. Although I believe the bill sponsored by Senator Lieberman is a good one, I believe that legislating accounting standards may set a troubling precedent. For this reason, it is my intention to sponsor the resolution offered by Senator Bradley to discourage the FASB from taking this action. Even experts can make mistakes and I share the view of our Nation's high tech and emerging companies, the major shareholder and investment groups, and the major accounting firms in opposing the FASB's efforts. I hope that FASB will consider the views of those opposed to its exposure draft, as well as the adverse impact of this proposal on the economy.

Again, Mr. Chairman, thank you for scheduling this morning's hearing. I look forward to the testimony of the witnesses.

## PREPARED STATEMENT OF SENATOR BARBARA BOXER

I want to thank the Chairman for holding a hearing on this important issue. And, let me say: this issue is of critical importance to California's industries and the California economy.

Stock options are an important tool for California's high-tech and start-up companies. These successful, growth-oriented enterprises use stock options to provide their employees with a stake in their workplace, leading to greater worker productivity and loyalty. These companies use stock options to hire the talented scientists, engineers and executives that are needed to make a high-risk enterprise a success.

These companies are truly a bright spot in California's economy. Our high-tech and biotech companies are highly competitive, exporting products with the "Made in America" symbol world-wide. Our small businesses and start-up companies are the source of most new jobs. These companies capture the spark of invention and turn it into new products and processes—meaning more jobs and new opportunities for Californians.

Congress recognized the importance of these growth-oriented companies during the recent budget debate. We included in the Budget Reconciliation bill a provision—which I strongly supported—that provides a target capital gains cut for investors in small businesses and start-up companies.

This targeted capital gains provision was a step forward. It will give small businesses and start-up companies greater access to needed capital. The FASB rule would be two steps backward. It would make it more difficult for many of these bright-spot companies to attract capital.

FASB's rule will counter the recent efforts of Congress and will damage the growth potential of many companies—all in the name of pursuing an abstract accounting theory. In my mind, that simply is not acceptable.

It is not acceptable to pursue an abstract accounting theory which has such damaging consequences to California's companies, and to companies across this nation.

During this morning's hearing we will hear from many of the industries that will feel the impact of the FASB proposal. I especially look forward to the testimony of Lisa Conte, President and CEO of Shaman Pharmaceuticals, a Northern California company working to develop new classes of pharmaceuticals derived from rain-forest plants.

Lisa runs one of the bright-spot companies that I was talking about: a company that went from one to 90 employees in 4 years after an initial public offering raised a substantial amount of capital. She provides *all* of her employees with stock options and is here to tell us that the FASB proposal is misdirected, unnecessary and harmful to the long-term growth potential of her industry.

I look forward to her testimony and the testimony of all the witnesses. Again, I want to thank the Chairman for holding a hearing on this important issue.

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## STATEMENT OF SENATOR CARL LEVIN

Thank you, Mr. Chairman, for this opportunity to testify on the rule that has been proposed by the private, independent Financial Accounting Standards Board or "FASB" to treat stock options like every other type of compensation.

Warren Buffett, who had hoped to testify on this matter, calls the current failure to treat stock options like other forms of compensation "the most egregious case of let's-not-face-up-to-reality behavior by executives and accountants" that he has ever seen. He strongly supports FASB's honest accounting rule which would end the practice of keeping stock options off the company books as an expense—the practice which has led me to call stock options "stealth compensation."

In his letter to this subcommittee, Mr. Buffett urges you to consider one of Abraham Lincoln's favorite riddles:

> "How many legs does a dog have if you call his tail a leg? The answer is four, because calling a tail a leg does not make it a leg."

Likewise, treating stock option awards as if they weren't compensation doesn't change the fact that they are compensation and should be accounted for as compensation.

But before I go into the substance of stock option accounting, let me express my concern about a preliminary issue—whether Congress should reverse a FASB accounting rule.

Congress has never reversed a FASB accounting rule, and it is my strong belief and that of those far more experienced than I—including Arthur Levitt, Chairman of the SEC—that Congress shouldn't start now. FASB is an independent, private

body of accounting experts whose sole charge is to develop accounting principles that accurately reflect economic events.

Reversing a FASB accounting rule through legislation would politicize what is supposed to be a neutral process. Reversing a FASB accounting rule would jeopardize the credibility and reliability of corporate financial statements which are key to a well-functioning economy. It would open a Pandora's box of special interest lobbying for legislation to overturn the decisions of independent accounting experts. As Richard Breeden, former head of the SEC, has put it, "the idea of Congress setting any specific accounting principle by statute would be a disastrous precedent."

In addition to breaking important and longstanding precedent, legislating to reverse FASB at this point in time would be premature. FASB's proposed rule—the rule that is the subject of an intense lobbying campaign to reverse it—is just that, proposed. It is not final. The public comment period extends to the end of the year. Public hearings are planned for 1994, and a 3-year period follows in which FASB plans to field test its proposal and analyze individual company calculations of the proposed earnings charge. Legislative action before FASB's deliberative process has concluded would not only be unprecedented, it would be inappropriate and, as Mr. Levitt said during his confirmation hearing, it "would not be wise."

FASB's rule proposes to treat stock options as other compensation, as an expense to the company. As you can see from this chart, stock options are the only form of compensation today which is not treated as an expense on corporate books. FASB proposes to correct that anomaly. Salaries, annual bonuses, grants of stock, life and health insurance, retirement pay—all other forms of compensation—are treated as expenses. Only stock options are not.

In fact, *stock options are the only kind of executive pay which a company can deduct from its taxes as an expense but which it is not required to include in its books as an expense.*

This inconsistency has been used by many American corporate executives to great advantage. When the highest CEO pay figures are announced—figures of $127 million, $68 million and $64 million in 1992 alone—stock options typically comprise more than 90% of the total. *Business Week* has reported that CEO pay rose on average 56% from 1991 to 1992, due primarily to stock options. The *Wall Street Journal* reports that more than 9% of company stock is now set aside for executive stock options—that's triple the 3% set aside a few years ago. Compensation experts report that stock option grants are skyrocketing in size, signaling even more gargantuan returns in the future. At the same time, corporate performance is weak, and the disconnect between CEO pay and corporate performance continues.

Some think of stock options as a way to meet the pay-for-performance goal, because an executive only makes money if the stock price goes up. But that ignores some key facts. First, there are many types of performance-based pay, including performance-based cash bonuses, all of which are charged to earnings as expenses. Stock options should be treated the same way.

Second, the link between stock option pay and corporate performance is only half a link. For example, stock options impose no penalty for poor performance. If a stock price drops, an executive suffers no loss; he or she simply declines to exercise the option. Stockholders can't duck their losses so easily.

Worse, some companies undercut all pay-for-performance linkages by repricing stock options when the stock value of the company hasn't increased. Repricing occurs when a falling stock price renders stock options worthless; companies essentially replace the worthless options with new ones at the lower stock price. Executives can then make money even if the stock price never regains its original level.

A 1993 survey of 1100 major corporations by *Executive Compensation Reports,* which I'd like to have included in the hearing record, found that 112 companies or 10% of the total had engaged in option repricing in recent years. In a survey of 100 high tech firms based in Silicon Valley, which I also submit for the record, the *San Jose Mercury News* found that, from 1990 to 1991, 31 out of 100 companies engaged in repricing, 8 of them more than once. Some high tech firms have repriced their options 6 or 7 times, lowering the price even in consecutive years. Repricing stock options is actually pay for poor performance.

Still another practice destroying the pay-for-performance quality of stock options is the growing use of megagrants, where executives receive options for hundreds of thousands or even millions of shares. These large grants mean that a small increase in stock price can result in a significant increase in compensation. *Business Week* has reported on one CEO who makes $6 million for every $1 dollar increase in his company's stock price. When a small increase in the stock price translates into millions of dollars for an individual executive, that's not pay-for-performance.

Megagrants, repricings and the absence of any penalty for poor performance mean that stock options just aren't the perfect pay-for-performance mechanism some proponents claim.

In any event, stock option compensation should be charged to company earnings like every other form of compensation for at least three reasons. The first is honesty. Honest accounting requires costs to be reported, and stock options cost companies.

In response to the claim by some that options shouldn't be viewed as a cost because they aren't dollars out of a company's coffers, Warren Buffett sees "exciting possibilities to American corporations for instantly improving their reported profits." He then cites as an example eliminating the cost of insurance by paying for it with options. "Shareholders should understand," Mr. Buffett admonishes, "that companies incur costs when they deliver something of value to another party and not just when cash changes hands."

As FASB will tell you, financial statements that hide costs and inflate reported earnings do a disservice to everyone except, perhaps, the executives who are financially benefited. Such financial statements mislead investors and create distortions in the U.S. economy where U.S. CEO salaries are wildly out of sync with worker pay, with corporate profits and with the pay of CEOs in the rest of the world. This chart of typical CEO pay at mid-sized companies shows how CEO pay in the United States vastly outpaces CEO pay in the rest of the world. Our CEO pay is twice as high as that in Germany and Japan, five times as high as CEO pay in Korea. Stock options are a primary reason for this pay differential, yet this pay never once appears on company books as an expense. As long as stock options are not charged to earnings, stock option accounting won't be honest. It's as simple as that.

Second and equally compelling is that the failure to charge stock options to earnings is not just an omission of a real cost, it encourages use of what can be a significant drain on company capital.

CEOs exercising stock options drain hundreds of millions of dollars each year from the capital needed to make American companies more competitive. In one case last year, a CEO and his wife exercised options for $84 million, capital which their high tech company could have used to ease serious cash flow problems leading this year to two quarters of losses, extensive layoffs and a slash in stockholder dividends. For some companies, the drain on capital could come at a critical time when the company needs to solidify gains or weather temporary problems. For example, a study by Strategic Compensation and Research Associates found that, in 1991, executive pay rose 39% in the biotech industry at the same time company losses climbed 283%.

The millions of dollars going to feed the stock option frenzy are diverting capital from the research and development and capital improvements that companies need to become competitive. So it's not just where this money is going that's the problem; it's also where it's not going. Current accounting rules encourage companies to hand out stock options freely by allowing them to ignore the impact on the bottom line. But stock options are not a free lunch. They divert that capital from other productive uses. That hurts competitiveness, and that hurts all of us.

That's why this stealth compensation needs to be accounted for in a company's financial statement. As Warren Buffett puts it in his letter to this subcommittee:

> "It seems to me that the realities of stock options can be summarized quite simply: If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

Third, as I showed in an earlier chart, stock options are the only form of compensation not currently charged to earnings—the only one. FASB sees no justification for this distinction. Some argue that stock options should be treated differently because they are performance based. But that doesn't make sense. Performance-based stock options are no different from any other performance-based pay. Cash bonuses, for example, are often tied to performance. So are some stock grants. Both are charged to earnings. Does anyone seriously suggest that cash bonuses based upon performance be kept off the corporate books?

Others argue that stock options should be treated differently because, unlike cash bonuses and stock grants, their value has to be estimated and that can't be done reliably. Warren Buffett, however, says that it's "both silly and cynical to say that an important item of cost should not be recognized simply because it can't be quantified" with great precision. He notes that "accounting abounds with imprecision"—mentioning estimates for the useful life of a piece of equipment, a bank's projected annual loan loss, and often incorrect guesses about annual insurance losses. Yet all of these costs are now included when calculating earnings.

If lack of precision were really the issue, this problem could be cured by charging earnings on the date when stock options are exercised and their value can be more precisely determined. But you won't be hearing opponents of FASB's proposal argue for that solution. They want it both ways—ignoring stock options as an expense when calculating earnings, but including them as an expense when calculating taxes.

You will hear today that stock options should be kept off the books because recognizing the cost will hurt the economy by depressing companies' reported earnings. But an honest accounting of stock options won't have that type of economic impact. As this chart shows, of the 3.7 million corporations in the United States today, 99% are small private businesses that don't use stock options. *None* of these businesses, representing 99% of U.S. corporations, will be affected by FASB's ruling at all. And that chart doesn't even take into account partnerships and sole proprietorships that account for another 16 million businesses—those businesses don't use stock period and certainly won't be affected by a FASB ruling on stock options.

In fact, there is only one small group of companies in the country that argue they will feel a significant impact from the proposed FASB rule. That is the group here today. They variously characterize themselves as high tech firms or emerging growth companies.

But current estimates of the size of the high tech community put it at about 100,000 small and large firms across the country. Most are private businesses that don't use stock options. To see how few do use stock options, consider that, in the whole country, there are only 12,000 publicly traded companies, 800 companies with an Initial Public Offering pending at the SEC (signaling an intention to go public), and 5,700 companies that participate in Over The Counter trading and presumably are also considering going public. Together these companies total only 18,500. Assuming half are high tech companies—a generous assumption since the high tech community makes up less than 3% of all U.S. corporations—only 9,250 companies or less than 10% of the high tech community are likely to use stock options. That means 90,000 high tech firms, or 90% of the high tech community, don't use stock options and won't be affected at all by the proposed FASB rule. The companies before you today thus do not represent the high tech community as a whole. In fact, they are the tail trying to wag the dog.

The companies testifying today do use stock options heavily and if the FASB rule were to become final, they would have to begin reporting this compensation expense on their books. The fear they have is that this honest accounting will require them to report lower earnings which in turn will cause their stock price to drop. That's a common argument made by the corporate community whenever FASB proposes a new earnings charge.

But two examples show why the claim that reduced earnings invariably lead to lower stock prices is untrue. In 1992, FASB required companies to charge their earnings for the first time for expenses associated with retiree health benefits. Those charges are far larger than any associated with stock options. Yet company stock prices were not only largely unaffected, the market as a whole has continued to rise. Market observers explain that these health charges recognized expenses that everyone already knew existed and, thus, did not alter the market's evaluation of the affected companies. The same will hold true for stock options. The second example is the Coca-Cola Co. which, in 1991, gave its CEO stock worth $60 million. Because it gave him stock—rather than stock options—the company was required to charge the entire amount to earnings. Its stock price did not drop. There was no investor flight.

Warren Buffett calls this argument by the startup companies "financial schizophrenia." He says in his letter to the subcommittee that "the people making this argument want managers at those companies to tell their employees that the options given them are immensely valuable while they simultaneously tell the owners of the corporation that the options are cost-free." I urge you to study his comments on this type of thinking and his description of what he calls the "absurdities" to which it leads.

There is also a second absurdity: the practice of these companies in claiming stock option compensation as an expense when calculating their taxes, but omitting them from their books when calculating earnings. Again, they want it both ways. Congress shouldn't reverse FASB's honest accounting rule which will not let them have it both ways.

One last point. Several witnesses today will argue that stock options are not an executive pay issue, but an employee pay issue because their companies give stock options to all employees. Some of these companies do in fact distribute stock options broadly, but they are the rare exception to the rule. First, 99% of all U.S. corporations don't use stock options at all. Of the less than 1% that do use them, a 1992

survey by *Executive Compensation Reports* of 1100 companies found that only 16, or 0.02%, gave stock options to all employees. The *Wall Street Journal* has reported that less than 5% of U.S. companies using stock options give them to anyone below management. Again, the group before you today is an exception, but in the vast majority of U.S. companies using them, stock options are exclusively for executives.

And the two bills introduced by Senator Lieberman and Senator Bradley calling for reversal of FASB's honest accounting rule don't limit their reversal to high tech companies or to companies with broadly based stock option plans. They would perpetuate what FASB considers inaccurate accounting for 100% of U.S. corporations.

## Conclusion

Executive pay is out of whack with corporate performance today, and a primary reason is stock options. Current accounting rules keep this growing form of executive pay off the corporate books as an expense, hiding its true cost and fueling excessive pay. It isn't honest, and it isn't right.

Recognizing the cost of stock options would strengthen the credibility of corporate financial statements; expose and hopefully slow their drain on company capital; and subject stock option compensation to the market discipline that happens only when a company's bottom line is affected.

I introduced legislation on this issue to induce FASB to put into place the stock option accounting reform it had been promising for a decade. FASB is the right body to be setting accounting standards; my bill sought simply to induce them to act as they have long promised. I and Senators Simpson, Pryor, Boren and Daschle would welcome your addition to our bill. While our goal is to induce FASB to get on with the job they promised of reforming stock option accounting, enactment of legislation to reverse FASB's independent judgment on this issue would be both unprecedented and unwise. I urge you against that course of action.

I ask consent to include in the hearing record the charts and surveys I've described. I also ask to include statements from the AFL–CIO and Consumer Federation of America.

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WARREN E. BUFFETT, CHAIRMAN

October 18, 1993

The Honorable Christopher Dodd
Chairman, Securities Subcommittee
of Committee on Banking, Housing
& Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510-6075

Dear Mr. Chairman:

I regret that I will not be able to attend your subcommittee meeting on October 21.

Could I have appeared there, I would have wished to make certain points, which I will distill here. First among these is the fact that I do not object to the intelligent use of stock options. I have often voted for their issuance, both as a director and as a substantial owner of the issuing corporations making use of them.

I do, however, object to the improper stock-option accounting now practiced. I summarized my views on that subject in the 1992 Annual Report of Berkshire Hathaway and I would like to repeat those comments here:

> Managers thinking about accounting issues should never forget one of Abraham Lincoln's favorite riddles: "How many legs does a dog have if you call his tail a leg?" The answer: "Four, because calling a tail a leg does not make it a leg." It behooves managers to remember that Abe's right even if an auditor is willing to certify that the tail is a leg.
>
> The most egregious case of let's-not-face-up-to-reality behavior by executives and accountants has occurred in the world of stock options. The lack of logic is not accidental: For decades, much of the business world has waged war against accounting rulemakers, trying to keep the costs of stock options from being reflected in the profits of the corporations that issue them.

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Typically, executives have argued that options are hard to value and that therefore their costs should be ignored. At other times managers have said that assigning a cost to options would injure small start-up businesses. Sometimes they have even solemnly declared that "out-of-the-money" options (those with an exercise price equal to or above the current market price) have no value when they are issued.

Oddly, the Council of Institutional Investors has chimed in with a variation on that theme, opining that options should not be viewed as a cost because they "aren't dollars out of a company's coffers." I see this line of reasoning as offering exciting possibilities to American corporations for instantly improving their reported profits. For example, they could eliminate the cost of insurance by paying for it with options. So if you're a CEO and subscribe to this "no cash-no cost" theory of accounting, I'll make you an offer you can't refuse: Give us a call at Berkshire and we will happily sell you insurance in exchange for a bundle of long-term options on your company's stock.

Shareholders should understand that companies incur costs when they deliver something of value to another party and not just when cash changes hands. Moreover, it is both silly and cynical to say that an important item of cost should not be recognized simply because it can't be quantified with pinpoint precision. Right now, accounting abounds with imprecision. After all, no manager or auditor knows how long a 747 is going to last, which means he also does not know what the yearly depreciation charge for the plane should be. No one knows with any certainty what a bank's annual loan loss charge ought to be. And the estimates of losses that property-casualty companies make are notoriously inaccurate.

Does this mean that these important items of cost should be ignored simply because they can't be quantified with absolute accuracy? Of course not. Rather, these costs should be estimated by honest and experienced people and then recorded. When you get right down to it, what other item of major but hard-to-precisely-calculate cost — other, that is, than stock options — does the accounting profession say should be ignored in the calculation of earnings?

Moreover, options are just not that difficult to value. Admittedly, the difficulty is increased by the fact that the options given to executives are restricted in various ways. These restrictions affect value. They do not, however, eliminate it. In fact, since I'm in the mood for offers, I'll make one to any executive who is granted a restricted option, even though it may be out of the money: On the day of issue, Berkshire will pay him or her a substantial sum for the right to any future gain he or she realizes on the option. So if you find a CEO who says his newly-issued options have little or no value, tell him to try us out. In truth, we have far more confidence in our ability to determine an appropriate price to pay for an option than we have in our ability to determine the proper depreciation rate for our corporate jet.

It seems to me that the realities of stock options can be summarized quite simply: If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?

With over six months having passed since those questions were posed, I have had no one heap answers upon me.

Instead, as the debate about option accounting has gone forward, "sweep-the-costs-under-the-rug" proponents have argued fervently for *disclosure* — for the presentation of all relevant information about options in the footnotes to the financial statements, rather than in the statements themselves. In that manner, they say, investors can be informed about the costs of options without these costs actually hurting net income and earnings per share.

This approach, so the argument proceeds, is especially needed for young companies: They will find new capital too expensive if they must charge against earnings the full compensation costs implicit in the value of the options they issue. In effect, the people making this argument want managers at those companies to tell their employees that the options given them are immensely valuable while they simultaneously tell the owners of the corporation that the options are cost-free. This financial schizophrenia, so it is argued, fosters the national interest, in that it aids entrepreneurs and the start-up companies we need to reinvigorate the economy.

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Let me point out the absurdities to which that line of thought leads. For example, it is also in the national interest that American industry spend significant sums on research and development. To encourage business to increase such spending, we might allow these costs, too, to be recorded only in the footnotes so that they do not reduce reported earnings. In other words, once you adopt the idea of pursuing social goals by mandating bizarre accounting, the possibilities are endless.

Indeed, I would argue that the "national-interest" theory is not only misguided, but wrong. True international competitiveness is achieved by reducing costs, not ignoring them. Over time, capital markets will also function more rationally when logical and even-handed accounting standards, rather than the "feel-good" variety, are followed.

Back in 1937, Benjamin Graham, the father of Security Analysis and, in my opinion, the best thinker the investment profession has ever had, wrote a satire on accounting. In it, he described the gimmicks that companies could employ to inflate reported earnings, even though economic reality changed not at all. Among Graham's most hilarious suggestions — because the thought seemed so far fetched — was a proposition that all employees of a company be paid in options. He pointed out that this arrangement would eliminate all labor costs (or, more precisely, eliminate the need to record them) and do wonders for the bottom line.

Today, in the world of stock options, we have life imitating satire. So far, of course, companies have largely substituted option compensation for cash compensation only when paying managers. But there is no reason that this substitution can't spread, as corporate executives catch on to the possibility of inflating earnings without actually improving the economics of their businesses.

One close-to-home example, involving Berkshire Hathaway and its 20,000 employees: I would have no problem inducing each of them to accept an annual grant of out-of-the-money options worth $3,000 at issuance in exchange for a $2,000 reduction in annual cash compensation. Were we to effect such an exchange, our pre-tax earnings would improve by $40 million — but our shareholders would be $20 million poorer. Would someone care to argue that that would be in the national interest?

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Many years ago, I heard a story — undoubtedly apocryphal — about a state legislator who introduced a bill to change the value of pi from 3.14159 to an even 3.0 so that mathematics could be made less difficult for the children of his constituents. If a well-intentioned Congress tries to pursue social goals by mandating unsound accounting principles, it will be following in the footsteps of that well-intentioned legislator.

Sincerely,

Warren E. Buffett

WEB/db

## STATEMENT OF THE AMERICAN BUSINESS CONFERENCE

The American Business Conference (ABC) congratulates the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs for holding a hearing on the Financial Accounting Standards Board (FASB) Exposure Draft "Accounting for Stock-based Compensation."

This exposure draft and the very serious issues it raises deserve greater public attention and consideration. ABC is pleased to have an opportunity to submit our written views on this matter in the hope that we can play a constructive role in the subcommittee's work. In addition to this written statement we are also submitting a copy of our 1992 pamphlet "Participation, Commitment, and Investment: Stock Options and High Growth Companies," and ask that it also be included in the hearing record.

### USE OF OPTIONS BY ABC COMPANIES

ABC is an organization of chief executives of very fast growing midsize American companies. The prudent use of stock options has been indispensable for the continuing success of ABC firms and, indeed, for most of America's great entrepreneurial companies. Our members typically cite three main purposes that options fulfill:

- Options help ABC firms to attract and keep talented employees who might otherwise be drawn to larger, richer companies.
- Options align the interests of employees with the interests of shareholders.
- And finally, because the issuance of options does not diminish cash flow, ABC companies are able to plow back profits into new investments for future growth.

A 1992 survey of ABC membership, upon which the attached pamphlet is based, reveals that stock options are far from being the private perquisite of a privileged few in top management.

- 88% of the options issued by ABC companies go to personnel other than the chief executive officer; 19% of the ABC CEO's eligible to receive options between 1990–1992 received no options at all.
- 61% of ABC firms extend option eligibility to middle managers; 23% extend eligibility to all salaried employees; 5% extend eligibility to hourly as well as salaried employees.
- Between 1990–1992, 43% of stock options issued by ABC firms went to employees *below* the vice presidential level. In ABC firms in the high technology sector, 57% of the options went to employees *below* the vice presidential level.

### IMPACT OF THE FASB PROPOSAL

The FASB would mandate the deduction of the imputed value of options at issuance from income; in other words, stock options would be expensed. Eighty-three percent of ABC executives polled said that, in the event their firms were forced to expense options at issuance, they would likely either stop issuing options (28%) or restrict the distribution of options to top management and key personnel (55%).

These views are not unique to ABC members. Much evidence has been adduced from a variety of sources suggesting that the burden of expensing stock options would fall disproportionately upon small and medium size companies. For the Nation's largest firms, the expensing of options would make an insignificant dent in reported earnings. For smaller companies, with more modest revenues, expensing could in some years entirely eliminate reported earnings.

We do not believe that it is in the Nation's interest to adopt accounting changes that curtail the broad use of options in entrepreneurial companies and that is why ABC has consistently opposed the FASB proposal for expensing stock options.

### THE TECHNICAL MERITS OF EXPENSING

The accounting treatment of stock options has been on the FASB agenda since 1984. The protracted deliberation that ultimately resulted in this year's Exposure Draft is itself evidence that this technical issue is far from clear-cut. Reasonable and informed people can hold different views. There is nothing self-evident about FASB's proposal.

ABC members do not agree with the Board's reasoning that led it to recommend option valuation and expensing. Rather, ABC members believe that expensing options is inconsistent with financial theory. In financial theory, a charge to income represents a depletion of company resources. Issuing options does not deplete resources and hence should not be expensed. In our view, the value of options at issuance is best understood as a transfer of ownership by dilution. Prevailing accounting

practice satisfactorily captures that value by expressing options in terms of dilution to per-share income.

FASB's proposed departure from the *status quo* does not, in our view, promise better information for the financial marketplace or a significant gain in accounting neutrality. Indeed, we believe quite the opposite.

### The Technical Merits of the FASB Model

Quite apart from the technical merits for expensing, ABC believes that the FASB model for valuing options is flawed. The valuation models proposed by FASB, and the estimations those models require, we believe to be discriminatory toward smaller companies, start-up firms, and growth companies in general. We recommend that the subcommittee carefully consider the accuracy of these models as it scrutinizes the Exposure Draft. For its part, ABC will be sharing with FASB our on-going work on the ways in which the Board's proposed models do not consistently measure value across companies and over time.

### Concluding Observations

The release of the Exposure Draft came at a time of strong public concern about the alleged overcompensation of certain business executives. FASB insists that it was not influenced by this concern or the resulting efforts by some members of Congress to legislate the expensing of stock options.

We do not question FASB's assertion. Nonetheless, there remains a perception that in issuing the Exposure Draft FASB was responding to political pressure. That perception has led opponents of expensing to seek legislative recourse.

ABC does not believe, as a matter of principle, that accounting standards should be legislated. But Congress does have a role in this controversy. Congress in general and this subcommittee in particular can continue to monitor the regulatory process initiated by the release of the Exposure Draft.

It is crucial that the comment period provided by FASB be as open as possible. That means more than field-testing the various valuation models proposed in the Exposure Draft. It means a willingness on the part of all parties to keep an open mind and to reassess all past decisions, up to and including the initial decision to recommend the expensing of options. By keeping a steady light on the comment period, Congress and this subcommittee can do much to insure due regulatory process in this most important matter.

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## TESTIMONY OF INTEGRATED SYSTEMS, INCORPORATED

### Submitted by the Association of Publicly Traded Companies

Integrated Systems, Incorporated (ISI) is in the engineering software business with more than 250 employees and has grown steadily since it was founded in 1980. We are a leader in our business with approximately 30% of our sales coming from outside North America. Including distributors, sales representatives, vendors, etc., we estimate that more than 1,000 families depend directly or indirectly on ISI.

ISI was started without venture capital funding. The company operated on shoe string budgets until it went public in 1990. Without liberal stock options, it would not have been possible to attract talented individuals that have made ISI the success it is today.

Under current accounting rules, ISI has been profitable every year since founding. With the proposed accounting rules relating to stock options, the company would have reported "losses" in many years and going public would have been difficult if not impossible.

Was going public worth it? Absolutely. The sales have grown by more than three times in the last three years. And the company with the resources to invest in international sales has seen the export sales grow by more than five times.

The biggest loss from the FASB proposal will be damage to our competitiveness with companies outside the U.S. Can we afford this with large trade imbalance and employment rates in the U.S.? Ultimately, the lack of competitiveness also hurts the company shareholder that the regulation is trying to protect.

## WRITTEN STATEMENT OF CEPHALON, INCORPORATED

SUBMITTED BY THE ASSOCIATION OF PUBLICLY TRADED COMPANIES

Cephalon, Incorporated is a biopharmaceutical company founded in 1987. Employment has grown each year at an average rate of over forty percent and today we have over two hundred employees. Cephalon's mission is to discover and develop pharmaceutical products for the treatment of neurological diseases and disorders. The company has concentrated its research programs on the prevention of neuronal death in several disorders, including amyotrophic lateral sclerosis (Lou Gehrig's disease) and peripheral neuropathy, Alzheimer's disease, head and spinal cord injury and stroke. There are currently few or no effective therapies for those disorders, which in the aggregate affect over five million people in the United States, placing a huge burden on our health care system. The company's lead product, Myotrophin, is in phase III clinical trials for the treatment of Lou Gehrig's disease.

Pharmaceutical development is an expensive and time-consuming process. Studies have shown that an average pharmaceutical product costs over $200 million and takes over ten years to develop. For a start up company in such an environment, cash conservation becomes critical.

Since its inception, Cephalon has granted stock options to all employees. As a small, publicly traded biotechnology company with no product sales, we find it difficult to compete against large pharmaceutical companies for qualified employees solely on the basis of salary. Granting stock options as a part of a total compensation package provides us with several advantages. Since large pharmaceutical companies typically only grant significant numbers of stock options to executive management, our option plan allows us to attract and retain qualified scientists and other non-executive employees while conserving our cash. This allows *all* employees to share in the financial success of our company, and provides a powerful financial incentive for all employees to act in the best interest of our shareholders.

The FASB proposal to require companies to take a charge against earnings when stock options are granted will almost certainly result in fewer options being granted. This would be unfortunate since stock options provide such a clear link between value provided to shareholders and financial rewards realized by employees. The Federal Government has already recognized the public policy benefits of such arrangements by providing a tax preference to holders of incentive stock options. It would be unfortunate if these public policy benefits were cancelled out by actions taken by the FASB. Whether or not the FASB proposal represents sound accounting is questionable; all the major public accounting firms oppose the proposal. It is clear that the proposed procedures will damage the competitiveness of small companies and that they are contrary to public policy. As such, they should not be implemented.

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## WRITTEN STATEMENT OF PARAGON MORTGAGE CORPORATION

SUBMITTED BY THE ASSOCIATION OF PUBLICLY TRADED COMPANIES

Paragon Mortgage Corporation is a five year old residential mortgage banking company located outside Atlanta, Georgia with offices in Georgia, Florida, Illinois, Tennessee, Texas and Colorado. Paragon provides mortgage funds directly to homeowners for the purpose of financing single family residential dwellings. Paragon is listed on the Nasdaq Small Cap Stock Exchange.

From its *de novo* start up in 1988, Paragon has experienced steady and rapid growth to become one of the stronger mortgage banking firms in the southeastern United States with loan production volume approaching three quarters of a billion dollars annually, which translates into approximately 7,500 real estate mortgages provided for homeowners. Paragon is an approved lender of the Federal National Mortgage Association, Government National Mortgage Association, FHA, VA and the Farmers Home Administration as well as representing 100 other private investors such as: General Electric, Chemical Bank and numerous others of similar quality.

Paragon has experienced significant industry recognition for its rapid growth and use of unique products such as: the Farmers Home Administration Loan Products, FHA's 203k substantial rehabilitation products as well as being named in a *Wall Street Journal* survey, "The Number One Minority Lender" in the state of Georgia. Paragon's CEO was also a finalist in the "Southeastern United States Entrepreneur of the Year" Competition.

In September 1989, Paragon became a publicly owned company through an initial public offering and achieved a Nasdaq listing in August 1991 and has been a profitable investment for its shareholders practically since its inception.

A significant amount of the success of Paragon Mortgage Corporation can be attributed to the fact that stock options were used as a key incentive compensation element for a significant number of our employees as well as senior management. The founders of the company worked for nearly the first two years without cash compensation and were compensated only in the form of stock options. Numerous other employees worked at a pay level below what they would normally have been able to command in the public market because of their faith in the company and their ownership in the company through stock options.

Initially the company provided stock options to employees at all levels from the most senior management down to the clerical level. As the company has continued to grow and has added a large number of employees, the depth of the stock options in the organization has been limited. Stock options have been a very important element in the growth of the company and its ability to retain top quality employees when it was unable to pay them the levels of compensations they would have been able to attain with other firms in the industry.

Paragon attained profitability approximately 2½ years after its inception and has continued to be profitable (with a couple of quarterly exceptions) since that time. Using the Black-Scholes method to compute the charge to earnings which would be mandated by FASB, it was determined that approximately 2.5 million dollars would have had to have been written off against Paragon's earnings since the inception of the company as a result of the granting of stock options. Had this method been in place at the time the company was founded, we would have been unable to grant stock options almost of any kind, which could have possibly precluded the company from having anywhere near the success that it has had or to have survived at all. This charge of 2.5 million dollars to earnings would have represented more than the total profit of Paragon since its inception in 1988.

Paragon has also employed the use of stock options for acquisitions and service providers which enabled us to reduce our cash outlay when we could least afford it.

As you can clearly see, the importance of stock options, as they relate to publicly traded companies such as Paragon, can have a direct impact on the success or even survival of a company of this type. It is our opinion that this charge to earnings is already borne by the shareholders of the company through the dilution which they experience through the issuance and exercising of stock options. It is pointless in our opinion to have this charge appear again, especially when it is done purely on a hypothetical basis as to its application. No one knows where the market will go and whether or not options may or may not be exercised and whether or not the company will continue to be successful especially in light of the fact that if the FASB ruling is put in place, many companies may in fact not be successful.

The bottom line is that stock options are a very important tool which can be used by the management of publicly traded companies to attract the highest quality of employee and to provide jobs for significantly large numbers of additional employees through the growth of the company which can be supported through stock options. This certainly falls into the "if it ain't broke, don't fix it" category.

Corporations have utilized the granting of stock options for years and have prospered through the use of stock options. It certainly seems pointless at this time to add an additional burden of a charge to earnings to a company as a result of the use of options.

Thank you for this opportunity to present our feelings and opinions regarding this issue. We sincerely hope that you will realize and understand the severe financial impact that this change in accounting procedures would have on rapidly growing small public companies who are acknowledged to be the source for most new jobs in America.

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## STATEMENT OF FREDERIC W. COOK

President, Frederic W. Cook & Co., Compensation Consultants
Member, FASB Stock Option Task Force

### Statement of Consulting Firms on FASB Stock Option Proposal

The undersigned representatives of eight firms which have compensation consulting practices submit this statement regarding the FASB's proposal to require the

recognition of an accounting expense for employee stock options using option-pricing models. Collectively, we are involved in the design of equity-based incentives for key employees in many large U.S. and multi-national corporations and in a number of smaller public and private corporations. As such, we are aware of the financial and incentive effects of stock options and other equity-based incentives. We expect to be involved in helping corporations adjust their practices to any new accounting standard for stock options and are knowledgeable about the effects any new standard will have on incentive practices.

We strongly support a "disclosure-based" approach to stock option values instead of requiring such values to be expensed in income statements. We believe the lack of agreement on how to measure the value or costs of employee stock options argues *against* the recognition of such values on income statements. However, it does not argue against greater and more uniform *disclosure* of stock option information to shareholders so that they can estimate costs and impose discipline on boards that grant options.

Our reasons for recommending *against* expense recognition for employee stock options granted at or above market value are:

1. We acknowledge options have a "value" to the employees who receive them. Their value is not zero. But this value cannot be measured with any acceptable degree of accuracy. And it does not follow that, because something granted has a value, it has to have a "cost" to the grantor.

2. The option-pricing models recommended for use by the FASB in determining expense were developed for publicly traded options. Employee options are substantially different, and there is no evidence the "values" such models produce for employees reflect the real value of such options in terms of foregone compensation.

3. Consultants use various financial models in valuing options in conducting surveys for clients and in advising clients on how many options to grant. But there is no agreement among us as to the models or assumptions to use. In a test conducted by the FASB in which a number of consultants participated, a *wide* variation in values resulted when valuing options for identical companies at identical prices. We believe the same wide variation would result if a similar test were conducted among investment bankers using their proprietary models for publicly traded options.

4. We believe the results of applying option-pricing models developed for publicly traded options to employee options substantially *overstate* their values because of the special characteristics of employee options (vesting, forfeitability and nontransferability). Adjustments proposed by the FASB do not adequately address these differences. Adopting a new accounting standard which imposes a higher "expense" than the perceived value delivered will result in a cutback in the number of options granted or an elimination of the use of this valuable device for providing equity incentives to create employee owners.

5. If option use is cut back, as it will be if the FASB proposal is adopted, we believe companies will *not* substitute additional compensation of equal value to former option recipients. Certainly top executives will continue to receive significant equity incentives, regardless of what the FASB does. The impact will be felt most sharply at middle management and lower levels. This will exacerbate the compensation gap between top executives and the rest of the organization. Employee options are a democratizing force in American industry whose use should be encouraged rather than discouraged.

We support the FASB in one of the major changes proposed in its new standard, namely to eliminate the present accounting inconsistency between time-vesting and performance-vesting grants for all equity-based grants, except those payable in cash. This would substantially address one of the main reasons the stock compensation project was added to the FASB's agenda in 1984. However, the FASB is linking elimination of the distinction between time-vesting and performance-vesting grants to acceptance of an accounting expense for stock options. We see no reason why "leveling the playing field" between performance-based and time-based grants, which is a desirable objective, should be held hostage to requiring an accounting expense for stock options which is controversial and unwarranted.

Finally, we also like to express support for maintaining the non-compensatory exemption for broad-based employee grants which meet certain requirements. This exemption is contained in the present accounting standard but would be eliminated if the FASB proposal is adopted. The present exemption permits companies to offer all-employee stock purchase and option plans at modest discounts to market (up to 15%) on nondiscriminatory terms without accounting expense. These plans have been recognized by Congress as deserving of support and favorable tax treatment since 1964 (IRC §423). Without the accounting exemption, however, we predict wholesale termination of these worthwhile plans.

In summary, our views are that the FASB should adopt a new accounting standard for stock options and other equity-based grants to employees which:

1. Increases disclosure to shareholders of the value and dilutive effect of stock options granted to employees,
2. Eliminates the accounting distinction between performance-based and time-based equity grants without requiring an accounting expense for "at-the-money" stock options, and
3. Maintains the present non-compensatory exemption for broad-based employee grants.

Our purpose in this statement is to present views and recommendations which are compatible with and an extension of the major recommendation of the coalition of users and preparers of financial statements and the American Compensation Association which represents over 15,000 compensation professionals in over 1,000 U.S. corporations employing over 25 million people.

We hope you will find our views worthy of your support. We are prepared to meet with your committee or staff representatives to present and defend our views and to answer any questions you may have.

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## STATEMENT OF CAROLYN AVER

CHIEF FINANCIAL OFFICER, PARCPLACE SYSTEMS, INC.

on behalf of

THE SOFTWARE PUBLISHERS ASSOCIATION

Mr. Chairman and members of the subcommittee, thank you for the opportunity to submit testimony in connection with the proposal by the Financial Accounting Standards Board (FASB) to require companies to record a charge to their earnings upon the grant of an employee stock option. I am Carolyn Aver, the Chief Financial Officer of ParcPlace Systems. ParcPlace is a private company in the Silicon Valley of California which designs software development tools. I am testifying on behalf of the Software Publishers Association (SPA). SPA is the principal trade association of the personal computer software industry, with a membership of over 1,000 companies, representing 90 percent of U.S. software publishers. SPA members range from well-known companies such as Microsoft, Lotus and Symantec, to hundreds of smaller companies such as ParcPlace Systems, Inc. and Phoenix Technologies, Inc., all of which develop and market business, consumer, and education software. SPA members sold more than $30 billion of software in 1992, accounting for more than half of total worldwide software sales. I appreciate the opportunity to submit this testimony and the interest you have shown in this very important issue.

*SPA Opposes FASB Proposal to Charge Earnings for Employee Stock Option Grants*

On June 30, 1993, the Financial Accounting Standards Board (FASB) issued an exposure draft proposing that all companies charge their financial statement earnings for stock-based plans. The proposed rules will be fully effective in 1997. The exposure draft applies to both employee stock options and employee stock purchase plans (ESPP). The SPA opposes the finalization of the exposure draft because an earnings charge for stock options and ESPP's will critically weaken the ability of start-up technology companies, such as ParcPlace, to attract the talented employees they need to succeed and will greatly restrict their access to capital markets. Simply put, these proposed accounting rule changes threaten the very culture which has made the software industry successful.

The SPA joins with the American Electronics Association, the National Venture Capital Association, the Biotechnology Industry Organization, the Coalition for American Equity Expansion, and many others in seeking the withdrawal of the FASB exposure draft. SPA also would like to thank Senators Lieberman and Bradley, Representatives Eshoo and Payne, and all the members of Congress who have joined as cosponsors in their efforts to influence FASB to withdraw the exposure draft.

*ParcPlace is Representative of Small, Entrepreneurial Software Publishers*

ParcPlace is an ideal example of a small SPA member company who opposes the FASB exposure draft. ParcPlace's main product is VisualWorks, an object-oriented, client server, application development environment written in Smalltalk. The Smalltalk language was developed almost twenty years ago in a research lab at Xerox. Xerox had established the Palo Alto Research Center, Xerox PARC, in 1972, to develop new technologies for the copier company. Many of today's leading technologies

were developed at PARC including laser printers, Ethernets, and Graphical User Interface. However, Xerox was unable to capitalize on these technologies due in part to the inertia inherent in many large companies. Ultimately, these technologies were exploited more effectively by other companies such as Apple, leaving Xerox unable to capitalize on their investment.

In 1986, Xerox acknowledged the difficulty it had in commercializing some of its leading edge technologies and sanctioned the formation of several entrepreneurial "spin offs." At that time, the companies that were noted for success were small companies started in founder's garages, where founders and employees had an equity position. These companies had little money and employees worked day and night to achieve success. Xerox and the researchers working on Smalltalk wanted to duplicate this culture. In 1988 ParcPlace was created with Xerox contributing the technology, the researchers contributing their technical expertise and hard work, and a group of venture capitalists contributing money.

Today ParcPlace has 145 employees and annualized revenues of $25 million. Many hard years of work by the founders and a growing number of employees have been critical to ParcPlace's success. All employees at ParcPlace receive incentive stock options. We believe it is a critical component of the company's culture and success. The employees as a group own (including stock options) approximately 30% of the company, with founders owning 10%, senior management other than founders owning 13%, and the remainder of the employees owning 8%. From the founding of the Company, stock options have played a key role in recruiting and retaining employees. The founders were well respected employees at a large stable company, Xerox. An ownership position at ParcPlace was essential to them in taking the entrepreneurial risks of starting a new business.

ParcPlace has added 47 employees in the last year and stock options continue to play a key role in attracting these new employees. Bill Lyons joined ParcPlace as CEO 18 months ago. Bill had been the CEO of a $250 million software company, prior to joining ParcPlace. An equity position was so important to Bill that in addition to the stock options he was granted, he purchased an additional 3% of the Company at the latest Venture funding prices. I left a position as V.P. of Finance at Autodesk to join ParcPlace in March, wanting to return to a smaller entrepreneurial company. When I began working for Autodesk in 1984, it was a private company with 80 employees and $10 million in revenue. When I left to join ParcPlace, Autodesk was a public company with over 1,500 employees (all of whom had stock options) and in excess of $350 million in revenue. The ownership interest that each employee had was a critical factor to Autodesk's success. The ability for me to have an equity stake in ParcPlace through options was key in my decision to leave my position of Vice President of Finance in a larger, more secure company and join a much riskier small company.

After four years of operation and $12 million of venture capital investment, ParcPlace has had four consecutive quarters of profitability. The growth in revenue over the last four quarters is enabling ParcPlace to move to a more profitable business model. A profitable business model is critical in enabling a liquidity strategy for the venture capitalists who have invested in the company since 1988. If the proposed FASB changes were in effect today, ParcPlace's profit would be reduced by more than 30%. This would have a significant impact on the Company's ability to raise any additional capital it may need.

In addition, like many other growing technology companies, as ParcPlace looks forward toward a public offering, the impact of the new FASB proposal may have significant implications. First, since it would substantially decrease earnings for ParcPlace over the last four quarters, it would delay the ability of ParcPlace to go public. This in turn would have significant implications for the venture capitalists as it extends the period in investment. ParcPlace currently has working capital of $700,000 and is cash neutral on an operating basis. Its ability to raise cash if necessary is critical to the success of the company.

*FASB Proposal Would Have Serious Negative Impact on Software Industry*

The FASB proposal would require all companies to charge financial statement earnings for stock option grants and ESPP discounts. The resulting decrease in earnings, which for many software companies will be substantial, will force companies to reduce stock option grants and ESPP plans to protect earnings. Reducing stock awards will greatly reduce the ability of small start-up software companies to attract and retain the technical and managerial talent which they must have to develop new software technologies and successfully bring the resulting software products to market. ParcPlace offers stock and stock options to all its employees to entice them away from high-paying, secure jobs at larger companies. Such employees risk their futures on making ParcPlace successful. In addition, the potential earnings

charge will make it even more difficult for small, privately held companies, such as ParcPlace, to obtain the capital they need to grow by attracting venture capital and by selling stock in initial public offerings.

The computer software industry, which is one of the fastest growing industries in the United States today, consists primarily of small, entrepreneurial companies. Although SPA represents the largest U.S. software companies, such as Microsoft, Symantec and Lotus, many SPA members are small start-up companies with less than $50 million in annual revenue. ParcPlace is representative of such members and, like many other small companies, have relied heavily on stock options to compete for technical and managerial talent. SPA's larger members continue to offer stock options and ESPP to many employees. Microsoft and Symantec, for example, award stock options to all employees. A ShareData 1991 survey of high technology companies found that 89% of companies with less than 100 employees granted stock options to all employees. 35% of all companies surveyed granted stock options to all employees.

The software and high technology industries will be disproportionately harmed by the FASB proposal because these companies offer stock options to a greater percentage of their employees and because growth company stocks tend to experience higher price volatility. A June 3, 1993, *Wall Street Journal* article estimated the earnings impact of the FASB's proposed stock option and ESPP charge for high technology and other companies. SPA member Lotus would have been required to reduce its earnings by 49.6%; Microsoft's earnings would have fallen by 18.9%. Consumer products companies such as Coca-Cola and Proctor & Gamble were estimated to suffer respective earnings reductions of only 1.7% and 2.2%. Under the FASB exposure draft, software companies' reported earnings would be penalized because they provide their employees with the opportunity to share directly in the success of their labors.

Stock options give employees the chance to share in their company's success and provide the incentive for employees to make the substantial personal commitment required to make a start-up company successful. This entrepreneurial spirit is essential to the success of a start-up software company. Finalization of the FASB proposal will force many companies to reduce the opportunities for their employees to realize a bright future by helping to build a successful software company.

I have read many stories in the press regarding alleged "excessive" compensation earned by several U.S. corporate executives. Stock options were included in many of their compensation packages. Many believe that Senator Levin's pressure on the FASB to finalize their proposal results from his belief that an earnings charge for stock options will reduce future "abusive,'" excessive compensation awards. His belief is unfounded for two reasons. First, company shareholders are the appropriate point of control over executive compensation and the SEC has recently required companies to increase compensation-related proxy disclosures to increase shareholder awareness and control. Second, when companies are forced to reduce stock option grants and eliminate ESPP's, they will cut back benefits for lower-level employees first because they will still have to pay "the going rate" for top technical and managerial talent. The greatest negative impact will be on middle-class employees and their dreams of home ownership and college educations for their children will be dashed on the rocks of "fat cat" politics and misguided accounting notions.

*FASB Proposal Theoretically is Flawed*

The FASB's proposal to charge earnings for stock option grants and ESPP sales is clearly bad policy; the proposal is also *bad accounting.* The exposure draft is opposed by all of the Big 6 public accounting firms, the Council for Institutional Investors, the investment community, and U.S. corporations. Since the FASB's exposure draft is opposed by the auditors, users, and preparers of financial statements, it is difficult to understand why the FASB continues to proceed with the stock option proposal. Is this the rare case where FASB is right and everyone else is wrong?

While there are many technical accounting issues involved with the exposure draft, there are two issues of particular concern to SPA members—*capital and valuation.*

*FASB Fails to Distinguish Between Capital and Compensation Components*

The FASB exposure draft concludes that 100% of the value assigned to employee stock option grants and ESPP sales should be classified as compensation and charged against earnings. This conclusion is contrary to the fundamental purpose of employee stock options and ESPP sales—to give employees an *ownership interest* in their companies. To build a successful business in today's extremely competitive environment, companies need employees who view their role and contributions not as simply a job but as a commitment. When employees have an ownership interest

in their company, and have the opportunity to profit from their *sweat equity*, they are more willing to contribute the extra effort required to grow a successful business. While it is true that increases in the company's stock price will provide incremental remuneration to option holders and ESPP participants—this extra cash is no different from the wealth generated on founders' stock held by the original owners of the company. Yet the FASB exposure draft requires that option value be charged against earnings while the value generated by founders' stock is not. Many entrepreneurs have realized significant increases in wealth by working to build successful companies. The FASB exposure draft does not require an earnings charge for this form of capital "compensation". SPA believes that stock option grants and ESPP sales are also capital compensation and should not be charged against income statement earnings.

*FASB Valuation Methods Produce Speculative Results*

The FASB exposure draft assumes that existing option pricing models will accurately value employee stock options for purposes of computing a financial statement earnings charge. The SPA disputes the FASB's assumption. The two most common option pricing models, Black-Scholes and Cox-Ross-Rubenstein, were designed to value short-term, publicly traded investor options. Employee stock options are long-term, highly restricted, and non-transferable. The author of one of these models has publicly stated that his model will not accurately value employee stock options.

The exposure draft treats the option grant as an arms-length, bargained transaction between a willing investor and the market. Investors are able to sell a publicly traded option at will. Employee stock options are restricted by long-term vesting periods and employees often are encouraged to hold their options to the maximum term. The exposure draft's "*investor bias*" results in a significantly overstated value for employee stock options. The exposure draft assigns a "*minimum value*" to employee stock options representing the "interest free" loan to the employee who does not have to pay for the stock until exercise. This minimum value, which is often the most significant component of the value assigned to the options by the exposure draft, applies regardless of whether the stock price ever increases above the option exercise price. Employees generally only realize value from stock options when the market value of the stock exceeds the exercise price. Yet the exposure draft ignores this fundamental principle of employee stock option grants and forces companies to charge a minimum value against financial statement earnings. An example of the option valuation is attached to my testimony.

The exposure draft concludes that the appropriate time to measure the value of an employee stock option is on grant date. Yet the grant date is the time when the most uncertainty exists with respect to the final outcome of the option transaction. As a result, companies are forced to make assumptions about holding periods and forfeitures. Changes in assumptions can significantly change the value assigned to the option. Valuation uncertainties at grant date are so significant that Internal Revenue Service regulations under IRC section 83 do not permit unvested employee stock options to be valued for purposes of determining taxable compensation on grant date.

The models provide results which clearly are counter-intuitive when viewed from the perspective of an employee option holder. The higher the value on the grant date (generally equal to the option exercise price) and the higher the stock's price volatility, the greater the value assigned to the option by the exposure draft. To give an example, assume a stock that recently has experienced price swings of between $50 and $100 per share. The FASB's option pricing models tell us that this is a highly volatile stock. Such pricing models would assign a higher minimum value to options granted at $100 per share and a lower minimum value to options granted at $50 per share. As an option recipient, I can tell the committee that options with a lower exercise price are more valuable to me than options with a higher exercise price. Because employee stock options are restricted, price volatility generally decreases the value to employees. The FASB proposal would require a company to report a larger charge to earnings for the grant of options which have a lower value to the employee and a smaller charge to earnings for the grant of options which are more valuable to the employee. Such an approach defies logic.

*FASB Incorrectly Assumes Low Cost of Compliance*

Finally, the exposure draft assumes that the cost of compliance will be low because PC-based valuation software is commercially available at relatively modest prices. However, since current models do not produce accurate valuations for employee stock options, companies who desire to report accurate financial statement earnings will have to design models which still meet the minimum requirements of the exposure draft. Many companies will be forced to hire experts to help them con-

struct their own valuation models and pay their auditors additional fees to review and opine on the valuations. Small companies, which least can afford these incremental costs, will have the most difficult valuations because many are not publicly traded and have a short historical pricing period.

The capital and valuation issues and inaccuracies contained in the exposure draft will further confuse financial statement users, will reduce financial statement credibility, and will reduce comparability with international financial markets. The SPA believes that the accounting rules prohibit inaccurate entries to financial statements and therefore the exposure draft should be withdrawn.

*SPA Opposes FASB Proposal on Stock Option Accounting*

In conclusion, the FASB's proposal to charge financial statement earnings for stock option compensation is disastrous economic policy and bad accounting policy. The SPA requests the Congress to support our efforts to urge FASB to withdraw the exposure draft.

I thank the Chairman and the committee for the opportunity to offer SPA's comments.

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## STATEMENT OF CRAIG McCANN [1]

### SENIOR ECONOMIST, ECONOMIC ANALYSIS CORPORATION

### WHY (AND HOW) TO VALUE EMPLOYEE STOCK OPTIONS

> Companies incur costs whenever they deliver something of value to another party, and not just when cash changes hand. . . . If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go? [2]

### A POLICY MAKER'S GUIDE TO OPTIONS

Beginning in 1993, the SEC introduced new disclosure rules for stock options granted to executives as part of the compensation section of the proxy. Registrants were required to value stock options using either of two alternative approaches. They could report what the options would be worth at expiration, assuming the stock price rises at five percent per year and also at ten percent a year, or they could use an option-pricing model to estimate the value of the options on the grant date. The first approach calculates a *future* value, and the second a *present* value. For those registrants who chose a present value approach, the SEC did not dictate a computational method although most issuers chose to use a modified Black-Scholes model.

The adoption of these new disclosure rules generated a little more interest and comment than most SEC rule makings. The focus on executive pay caused consternation in many board rooms, although some saw the new disclosure rules as an antidote to be preferred to the proposals to surtax executive pay over some fixed amount. Truly vigorous opposition on the part of corporate America erupted with the decision of the Financial Accounting Standards Board, (FASB) on April 7, 1993, (by a vote of 6–1 as reported in the *Wall Street Journal* of April 8—but the final exposure draft of June 30, 1993 included no dissent) to require that companies not only value stock options granted to (all) employees as part of their compensation, but also recognize them as a compensation expense in reporting income. Groups representing executives and boards of directors enlisted institutional investors, shareholders' rights groups, all six of the Big Six accounting firms and Secretary of the Treasury Bensten to lobby the FASB against expensing [3] options.

FASB, the SEC and Congress have been inundated with reasoned petitions arguing that options should not be valued and expensed as part of companies public fil-

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[1] Copyright 1993. Senior Economist, Economic Analysis Corporation, 2049 Century Park East, Los Angeles, California 90067, formerly Senior Research Scholar, Office of Economic Analysis, U.S. Securities and Exchange Commission. The views expressed in this paper are the views of the author and do not necessarily reflect the views of the Commission or of the author's former colleagues on the staff of the Commission. The author wishes to thank Vance Anthony, Daniel Asquith, David Bizer, Jeff Davis, Walter Schuetze, the Chief Accountant at the SEC, and especially Susan E. Woodward, the Chief Economist at the SEC.

[2] Warren Buffett, "Chairman's Letter," *Berkshire Hathaway Annual Report for 1992,* 1993 p. 18.

[3] We use the term "expense" here to indicate that *at some point* the value of the options will be recognized as an expense.

ings. There are fundamental arguments about how corporate income ought to be measured. Opponents of the FASB rule have argued that options are an equity instrument, and as such, no treatment of them belongs on the income statement. Moreover, they argue, options written at-the-money are worth nothing when granted. And even if (or when) options do have value, the opponents add, methods for valuing options are exceedingly difficult and complex to use, and are misleading and unreliable. A second set of arguments goes beyond the issues of measuring income and option values and focuses on concerns that valuing and expensing options will result in inevitable and unfortunate repercussions in tax policy and on capital formation. These arguments, in particular the claim that the methods for pricing options are difficult to use and unreliable, inspired the writing of this article.

The goal here is thus twofold. First, to review the logic of the FASB decision and the objections raised to it, and second, to demonstrate, by giving the reader an intuitive and practical guide to the methods for valuing options, that these methods are not difficult to use, and that they produce values that make good economic sense and can be relied upon as estimates of what the options would sell for in the marketplace.

*Options as Equity Instruments*

The following comparison of two transactions having identical before-tax financial impact on shareholders serves to highlight the issues in the FASB decision:

Transaction #1: A vendor provides $10,000 of services to a firm, which pays the vendor with $10,000 worth of options.

Transaction #2: The vendor provides $10,000 worth of services. The firm then issues options to raise $10,000 in cash, and uses this cash to pay the vendor.

The economic substance of the two transactions is identical: $10,000 worth of services are bought and paid for; and $10,000 worth of outstanding options, issued by the firm, are created. In the first, options are used to pay the bill directly, and no expense is shown under the current accounting treatment for stock options granted to employees.[4] In the second, however, the company shows an expense of $10,000 against income when the bill is paid. The only difference in the transactions is that in the second, cash was collected for the options and then disbursed to the vendor. The first transaction should be thought of as simply a special case in which the vendor is the purchaser of the options. The shareholders, in principle, are indifferent to who provides the cash at the issuance of the options. Thus, it does not serve the shareholders well to expense one transaction on the income statement and not the other, economically identical, transaction.

The basic questions to be answered by the income statement are 1) What did the firm produce? (revenues), and What resources did it use up in producing them? (costs). To fail to include some costs because they are not paid for with cash, because they are uncertain, or because they are deferred, will mislead readers of financial statements into thinking that companies who use more options have lower costs, simply because some of the costs are not among the expenses in the income statement. To further see the inherent logic as to why all equity instruments granted as compensation should be expensed, consider the consequences if a firm paid all of its bills with options (or stock) without expensing them. It would appear that the cost of operations was zero, regardless of the level of resources used. Firms that exclude from cost calculations resources paid for with options are rather like governments that finance government expenditures with newly printed money (instead of money raised through taxes or bonds), and then argue that the new money "costs" their citizens nothing, despite the inflation that results and the real resources that are being diverted from private pursuits.

Those opposed to expensing options argue that it is sufficient and appropriate to simply reflect the presence of options in diluted earnings per share, and inappropriate to expense them. But other equity instruments, such as common stock and even options that are very similar to those at issue here (stock appreciation rights) are expensed when granted to employees as compensation. In the case of common stock, the expense is reported as the value of the stock (at market price if the stock is traded) at the date granted.

*Options Issued Out-of-the-Money*

Is an option worthless whenever it cannot be exercised for a profit? Consider the possible future outcomes of simply holding on to such an "out-of-the-money" option. The worst possible outcome is that the option simply expires with the stock selling

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[4] Under today's accounting, if options were issued in return for advertising or legal services, an expense would be recognized, but not if issued at- or below-the-money, to employees for services. Shareholders should actually prefer Transaction #1, see footnote 6.

below the exercise price (still out-of-the-money), and hence worth nothing. But there is also a possibility that it may expire with the stock selling well above the exercise price, and be worth the difference between the stock price and the exercise price. The average across the possible outcomes is clearly positive if there is any possibility that the option will expire in-the-money. For verification of their value, one need look no further than the business section of the morning newspaper to see the hundreds of at-the-money and out-of-the-money call options selling for positive, competitively determined, prices. While employee stock options usually have much longer terms to expiration than do traded options, the same logic implies that they too are valuable. If firms were to grant their employees traded options, the valuation task would be simple—the options' market prices would value the compensation.

*Option Value Reliability*

Option pricing models calculate the present value probability-weighted average of possible market values over the term of the option. The models do not "predict" what an option will be worth in 10 years but what it could be sold for today. Therefore the appropriate test is not whether they accurately predict the value of an option upon exercise but whether the models accurately estimate the price at which the options could be sold at the time of the grant. The ability of pricing models to predict the market price of short term options and longer term warrants (sold perhaps to raise cash to pay to employees, as in the above comparison) has been widely tested both in the market place and by business school researchers.[5]

Moreover, uncertainty about ultimate values should not and does not discourage use of probabilistic estimates for accounting purposes. For example, estimates of liabilities for retirement health benefits, litigation exposure, and environmental clean-up costs may be subject to large revisions. This is no reason to ignore the liability. Geological estimates of the reserves of a gold mine or an oil field are uncertain, yet no investor would consider such estimates, done by competent methods, to be unreliable to the point of being useless. Even a seemingly simple accounting choice, such as choosing a lifetime and depreciation schedule for a mainframe, is subject to potentially large *ex post* adjustments. To fail to expense options at all is to assign them a value of zero, which, given they may be worth far more than zero, is clearly incorrect.

*Tax Policy Implications*

Under current tax law, when a non-qualified option is exercised, the employee reports taxable income equal to the difference between the stock price and the exercise price times the number of options exercised and the company takes a deduction from taxable income of an equal amount. If the corporate and personal tax rates are equal, no net tax is paid. Thus, the U.S. Treasury has no incentive to move the tax event forward since no net revenue is collected. If the corporate tax rate is higher than the personal rate, (as it was prior to the passage of the recent tax bill) Treasury *loses* from advancing the tax date. Only if the personal tax rate *exceeds* the corporate rate is the net revenue greater than zero, and even then, it is not a new tax, but simply a net tax moved forward in time compared to current law. The gain to the Treasury is not the net tax, but the implicit interest earned from collecting the tax sooner rather than later.

Stock appreciation rights have incentive benefits which are almost identical to employee stock options and have far more favorable tax effects on the corporation. If taxation and not disclosure was the real concern firms would not use non-qualified stock options. Under the prevailing tax and accounting rules, companies using options as compensation take a tax deduction for an expense which they ignore in reporting their income to investors![6]

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[5] See Eric Noreen and Mark Wolfson, "Equilibrium Warrant Pricing Models and Accounting for Executive Stock Options," *Journal of Accounting Research* 19:2 Autumn 1981, Dan Galai, 'A Note on "Equilibrium Warrant Pricing Models and Accounting for Executive Stock Options",' *Journal of Accounting Research* 27:2 Autumn 1989, Dan Galai and Meir Schneller, "Pricing of Warrants and the Value of the Firm," *Journal of Finance* 33:5 December 1978, Beni Lauterbach and Paul Schultz, "Pricing Warrants: An Empirical Study of the Black-Scholes Model and Its Alternatives," *Journal of Finance* 45:4 September 1990.

[6] Scholes and Wolfson show that stock appreciation rights are essentially identical to stock options and have a small but positive tax advantage over options. They conclude that stock options are used in preference to stock appreciation rights because stock appreciation rights are expensed and under the old rules, options were not. In other words, companies were giving up real tax benefits in order to report higher earnings. Perhaps the new FASB rule will encourage greater use of stock appreciation rights. See Myron S. Scholes and Mark A. Wolfson, *Taxes and Business Strategy: A Planning Approach*, Prentice-Hall, Englewood Cliffs, NJ 1992, Ch. 10.

*Effect on Capital Formation*

Influential opponents of option expensing argue that small, growth companies that make extensive use of options would be forced to report lower net income if they expense options, and may, as a result, find it harder to raise capital. Supporters of the "threat to capital formation" argument contend on the one hand that investors are not misled by the current partial-disclosure and muddied accounting for options, but on the other, that investors will be deterred from investing in (socially or privately?) valuable ventures by lower reported earnings if options are expensed. Changing the accounting rules does not change the underlying profitability of a new venture: either investors are not misled by the current accounting, and will not change their investment plans, or investors are misled by current accounting, and when they learn that these firms are not as profitable as they thought, they will invest less, and appropriately so.

A persuasive case may be made for treating start-up companies as special, perhaps offering them tax breaks (indeed, they got one in the most recent budget bill) because of the socially valuable knowledge they generate. However, surely it is better public policy to do this straightforwardly, not through incomplete and inaccurate accounting. If the activities of small businesses truly have a special social value, there should be little objection to an outright subsidy. Capital formation should not have to come at the cost of misinformed investors.

*Does Accounting Matter?*

In the last twenty years accounting research has produced hundreds of studies of the impact of reported earnings on stock prices. The overwhelming consensus of these studies is that accounting numbers convey information and move stock prices. The most interesting of these studies for our purposes are those that examine the impact of changes in reported earnings that arise strictly from restatements due to changes in accounting method and have no impact on cash flow. When large companies make voluntary changes, (e.g., LIFO to FIFO) the impact on stock prices is nil; the market "sees through" the accounting, and behaves as if there is no new information. But when the change is imposed rather than voluntary (for example, FASB rulings on lease accounting, and retirement benefits), especially when the firms are small, stock prices do move, and they move in the same direction as the change in reported income. Generally speaking, for large companies, these studies find that stock price changes precede earnings announcements and that the adjustment to earnings surprises occur rapidly. For small companies, there is less pre-announcement anticipation and stock prices appear slower to adjust to unexpected changes in earnings.[7]

This research offers clear policy guidance. If accounting numbers don't matter because the markets always see through them, then there is no harm in getting the accounting right. If the accounting numbers do matter, then it is very important to get the accounting right. So, get the accounting right. Moreover, even if the markets can pierce the veil of accounting, surely there is merit in promoting consistency in reporting, simply to conserve on the efforts that small investors, financial analysts, and policy makers must make in reading the reports and their footnotes and fine print in order to evaluate firm performance.

## A User's Guide to Valuing Options

This section outlines the methods for implementing, on personal computers, the Black-Scholes and binomial methods for valuing stock options using publicly available data. The code for the programs used in this article is in Appendix 1. There are many other programs available from commercial vendors for computing option values.[8]

*Two Models*

The Black-Scholes option-pricing model yields a simple formula that gives the value of an option as a function of six parameters that define the option. The vari-

[7] This shows up empirically in the apparent ability of financial statement information to explain cross-sectional variation in stock price changes days and weeks following earnings announcements. See any recent volume of *Accounting Review* or *Journal of Accounting and Economics*. In particular see John Hand, "A Test of the Extended Functional Fixation Hypothesis," "Accounting Disclosures and the Market's Valuation of Oil and Gas Properties: Evaluation of Market Efficiency and Functional Fixation" and Seha Tinic, "A Perspective on the Stock Market's Fixation on Accounting Numbers," all in *Accounting Review* 65:4 October 1990.

[8] The spreadsheet routines are provided for illustration purposes only. They demonstrate how simple it has become to reasonably value option. They are not intended to influence investment decisions and should not be used for that purpose.

ations of Black-Scholes used to value options were designed for valuing "European-style" options—options that can be exercised only on the expiration date. Since most publicly traded call options are of very short term (less than 180 days), either dividends are not paid on the stock, or simple adjustments can be made to the Black-Scholes value to account for any dividend that is paid during the short life of the option. Since tradable options on non-dividend paying stocks are always worth more "alive" than "dead" (i.e., it never pays to exercise early), the Black-Scholes model performs very well indeed in pricing short-term American call options.

Employee stock options, on the other hand, are typically long-term (5, 10 or 15 years) and can be exercised early—after the vesting date but prior to the expiration date. The opportunity to exercise the "American-style" options early matters when companies are paying dividends. Since option holders, as opposed to actual stock holders, do not collect dividends, it may be to an option holder's advantage to exercise an option prior to the payment of a dividend, as stock prices (and with them, option prices) generally fall on the ex-dividend date.[9] The binomial model cannot be represented by a closed-form solution (single or multiple equations). It is solved using recursive techniques.[10] The binomial model is more adept at incorporating dividends, vesting restrictions and potential early exercise, and has a more intuitive construction than the Black-Scholes model.

*The Inputs*

The Black-Scholes and binomial models both require the following six inputs:

1. the grant date stock price,
2. the exercise price,
3. the number of years to expiration,
4. the risk-free interest rate,
5. the firm's expected annual dividend yield, and
6. its expected stock price volatility.

The first three inputs: grant date stock price, the exercise price and the number of years to expiration are specified in the grant. The risk-free interest rate commonly used for valuing traded options is the yield on the Treasury security maturing nearest the expiration date. For example, the yield on the 10-year Treasury bond around the time of the grant would be appropriate for a 10-year option and can be found in the market data section of most newspapers. The slight variations that occur in the risk-free rate from week to week and the fact that the risk-free rate may vary over the life of the option do not have a significant effect on the option's value.[11] The ready availability of long-term market interest rates and the fairly non-controversial choice for valuing options reduces the valuator's discretion to two inputs: volatility and dividend yield.

Long-term option values are more sensitive to both dividend yield and price volatility than to the risk-free interest rate. Option values are forward-looking, and depend not on past dividend yields and volatility, but on expected dividends and volatility over the life of the option. Still, history is some guide to the future, as both dividend yield and volatility display considerable persistence over time for many firms.

Some stock surveys calculate historic dividend yields dividing dividends paid during a year by the midpoint of the year's highest and lowest price which is correct only if the firm's stock price was at its low for half of the year and at its high for the other half of the year. A better approach is to divide the sum of the cash dividends paid during the past twelve months by the average daily closing price over

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[9] Lambert, Lanen & Larker report that about 5% of firms pay dividends on their stock options. This "dividend protection" should reduce the incentives for managers to reduce expected future dividend payouts to common stockholders in order to increase the value of their options. They document the tendency to self-serving dividend policy in response to the adoption of new executive stock option plans. See Richard A. Lambert, William N. Lanen, and David F. Larker, "Executive Stock Option Plans and Corporate Dividend Policy," *Journal of Financial and Quantitative Analysis* vol. 24, no. 4, December 1989 p. 409.

[10] "Recursive" refers to computational formulae that are "nested" in a self-referencing (recurs in itself) fashion. In the case of options, this means that at each date, the value of an option is the maximum of the value of the option exercised and the value of the option unexercised; if the option is not exercised, then its value at the next date is also the maximum of the value of the option exercised vs. unexercised, and so on. The binomial method thus begins with a distribution of possible stock price paths, and works backward over each path, to determine if and when, on each path, the option would be exercised, and given the exercise points, computes a present value.

[11] The values presented in Table 1 below were calculated assuming a 7.5% risk-free rate. They would be reduced on average by about 5% if a risk-free rate of 6.5% (a 14% change in the interest rate) had been chosen instead.

the same period, perhaps weighting more recent days' prices more heavily in the calculation. But depending on the company's particular circumstances, it may be possible to improve on this estimate considerably by examining pro forma earnings projections. The stability of most firms' dividend policy over time constrains the size of the mistake that can be made in estimating dividend yields.

Stock price volatility is the (annualized) standard deviation in the natural logarithms of adjusted stock returns adjusted for cash dividends, stock splits and stock dividends. The calculation of a standard deviation involves taking the average of the natural logs of returns (using daily or weekly or monthly data), subtracting the average from each log return, squaring this "deviation", summing up the squared deviations, and dividing the sum by the number of returns used in the calculation. The standard deviation is then annualized by multiplying it by the square root of the frequency of the trading period over which returns are calculated in one year ($\sqrt{253}$ for trading days, $\sqrt{52}$ for weeks and $\sqrt{12}$ for months). Once stock prices and dividend information are gathered this calculation can be done in minutes with a spreadsheet or pocket calculator. An example of the dividend yield and volatility calculations using monthly data is provided in Appendix 2.

*The Implementation*

Programmable calculators or personal computers make the implementation of option valuation models very simple once the estimates of dividend yield and price volatility are obtained. The Black-Scholes model is much easier to program than the binomial model, but inexpensive templates for popular spreadsheets, available from commercial vendors, make applying either model as easy as specifying the six inputs. Routines used in this paper to calculate variations of the Black-Scholes and binomial values were written to work in Lotus 123, Quattro Pro and Microsoft Excel and are provided in Appendix 1.

Table 1 presents representative option values for a range of common stock volatilities and dividend yields. It contains the Black-Scholes and binomial model values for at-the-money, ten-year options (the garden variety) that vest in two years, using dividend yields from 0 to 8 percent, and volatilities from 25 to 65 percent. Values are given for the option value as a percentage of the stock price. For example, when the stock price is $100, and the risk-free interest rate 7.5 percent, the Black-Scholes and binomial models both give a value of $56.60 to a ten-year, at the money option on a stock with a dividend yield of zero and a volatility of 25 percent. For a volatility of 25 percent but a dividend yield of 8 percent, the Black-Scholes value is $12.41 and the binomial value is $18.86. Since employee stock options can generally be exercised prior to expiration (but after vesting), the binomial model gives the more accurate value.

Table 1

Black-Scholes and binomial model values for 10-year at-the-money options, vesting after 2 years, on a $100 stock with a 7.5% p.a. prevailing risk-free interest rate.

| Black-Scholes and Binomial values. | | Volatility | | | | |
|---|---|---|---|---|---|---|
| | | .25 | .35 | .45 | .55 | .65 |
| Annual Dividend Yield | 0% | 56.60<br>56.60 | 62.40<br>62.40 | 68.48<br>68.48 | 74.27<br>74.27 | 79.46<br>79.46 |
| | 2% | 40.59<br>41.01 | 46.66<br>47.73 | 52.62<br>54.65 | 58.12<br>61.12 | 63.00<br>66.94 |
| | 4% | 28.28<br>30.66 | 34.33<br>38.32 | 40.02<br>45.71 | 45.17<br>52.44 | 49.69<br>58.44 |
| | 6% | 19.08<br>23.80 | 24.83<br>31.62 | 30.12<br>39.00 | 34.86<br>45.73 | 38.99<br>51.87 |
| | 8% | 12.41<br>18.86 | 17.63<br>26.48 | 22.42<br>33.65 | 26.70<br>40.31 | 30.44<br>46.32 |

For options granted at-the-money by firms with low dividend yields, the Black-Scholes and binomial values are nearly identical. For firms paying higher dividends, the differences become significant, and the differences vary with other factors such as the volatility and whether the option is in or out of the money. The difference between the Black-Scholes and binomial values is equal to the value that investors would place on the ability to exercise the option early.

Option holders will exercise early if the present value of expected dividends on the stock is greater than the "pure option value" (the amount by which the option value exceeds the amount the option is in-the-money). Stock holders collect dividends, but option holders do not. To see the critical role of the dividends, consider an option with an exercise price of zero. This option with a zero exercise price and the underlying stock have the same value if the stock pays no dividends. If the stock pays dividends, the stock is more valuable than the zero-exercise-price option. Generally speaking, option holders will find it optimal to exercise an option early only when the option is deep in-the-money (a zero-exercise-price option is as deep as it can get) and paying dividends. They will not exercise near-the-money options on low dividend paying stocks since holding the option has much less downside risk than holding the stock (see the sidebar alongside for a numerical example of this trade-off).

Consider an at-the-money call option with two periods remaining to expiration on a $100 stock. Assume that each quarter there is a 50/50 chance that the stock price will rise or fall by 10%, that a 5% dividend will be paid at the beginning of the second period and that the risk-free interest rate is 0. Figure 1 depicts the possible price paths for the stock and option

The dividend paid at the beginning of the second period will be $5.50 with probability .50 and $4.50 with probability .50. At the end of the second period the stock price will be $114.95 with probability .25, $94.05 with probability .50 and $76.95 with probability .25. The current stock price of $100 equals the expected stock price at the end of two periods, $95, plus the expected dividend of $5.

The option ends in-the-money $14.95 half the time (if the stock price rose the first period) and ends out-of-the money otherwise. At the end of the first period the option holder is faced with the decision to exercise the option, collecting the dividend and the expected price of the stock, or to hold the option, foregoing the dividend in favor of the expected (truncated) appreciation. As set up, the option holder will exercise the option if the stock price has risen to $110 in the first period, since for $100 the holder receives the dividend to be paid, $5.50, and the stock's expected price at the end of the second period of $104.50, for a net of $10, while the amount by which the option is expected to end in-the-money, and therefore its then current value unexercised, is only $7.475.

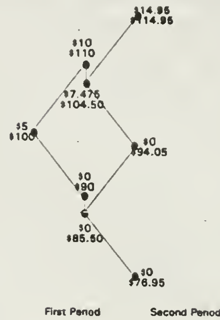



**Figure 1. The value of Early Exercise**

If the stock price falls in the first period it will definitely end out-of-the money in the second period. The price of the stock at the end of the first period, $90, is the sum of the expected second period closing given the stock price fell in the first period, $85.50, plus the dividend to be paid at the beginning of the second period, $4.50. The option will not be exercised at the end of the first period since it is out-of-the money. The option will trade at the beginning of the first period for $5 since it has a $10 value 50% of the time and no value 50% of the time.

The binomial model would correctly value the option at $5 at the beginning of the first period, but the standard Black-Scholes model, ignoring the option to exercise early, would incorrectly value the option at $3.75. Options on stocks that pay dividends are properly valued with the binomial model, which incorporates the value of early exercise.

The Black-Scholes and binomial option values are identical for stocks paying no dividends, holding constant the volatility. The intuition behind this is that if a stock never pays a dividend, it never pays to exercise a (call) option on the stock early. If it doesn't pay to exercise the option early, the difference in the value of an option that *cannot* be exercised early, vs. one that can, is zero.

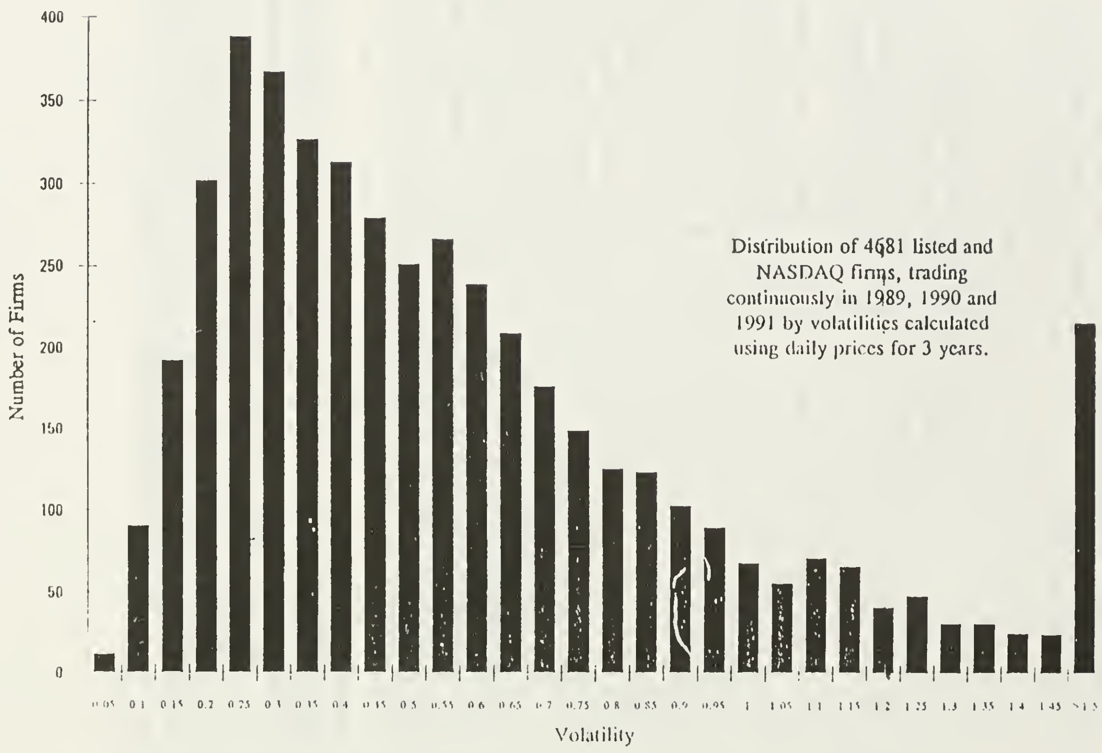
A stock with a higher volatility, other things equal, will have a more valuable option. An option on a volatile stock may be more valuable than an option on a stock that has a higher expected return but is less volatile. Even if an option is deep in-the-money, it can never be worth *more* than the underlying stock. As an option goes into-the-money, the option value approaches the stock value, but never exceeds it. The least valuable options are those on high dividend, low volatility stocks, and the most valuable are those on zero dividend, high volatility stocks. Option values on stocks of fast-growing, startup companies with low dividends and volatile stock prices can be found in the upper right hand corner of Table 1.

Also note that both the Black-Scholes and binomial values for stocks paying dividends at a rate of 8 percent per year are very low, although the early-exercisable option (American) is worth about fifty percent more than the non-early exercisable option (European). The intuition here is that the inherent value in an option lies in anticipated increases in stock prices. Stocks that pay high dividend yields, like public utilities, give their investors relatively more of their return in the form of dividends, rather than in stock price increases. Therefore, options on such stocks are not worth very much, other things equal. The option that can be exercised early, valued correctly by the binomial model (the lower number), is worth more than the non-early exercisable option, valued correctly by the Black-Scholes model, because, as we demonstrated above, it may be optimal to exercise the option prior to expiration in order to collect the future stream of dividends. For a company paying no dividend, (nearly half of all exchange-listed and NASDAQ national market system companies that traded throughout 1989–1991) binomial and Black-Scholes values vary from 55% to 80% of the exercise price. The proportionate difference in option values across dividend yields decreases as volatility rises and increases across volatilities as dividend yields rise. This pattern offers guidance on where accuracy is relatively more important. A correct volatility forecast is relatively more important for high dividend paying stocks than for low dividend paying stocks; the accuracy of the dividend yield forecast is relatively more important for less volatile stocks than for more volatile stocks.

*Observed Volatilities and Dividend Yields*

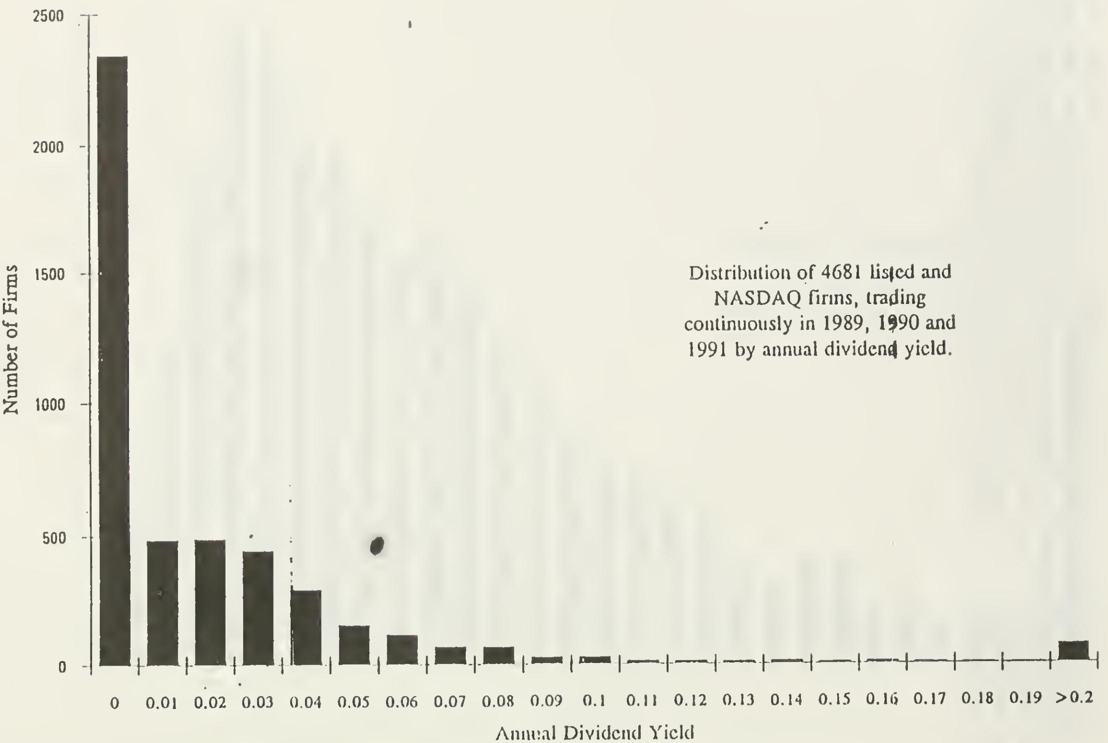
The distribution of the annualized volatility of return for 4,681 NYSE, AMEX and NASDAQ firms whose stock traded continuously for all of 1989, 1990, and 1991 in Figure 2 shows a wide range of individual firm volatilities. The volatilities were estimated by the method provided in Appendix 2 using daily prices for three years. The most frequent volatility range is 20 to 25 percent; only about 12 percent of the sample have volatilities lower than this. The distribution is skewed toward the right with a median of 54 percent and an average of 67 percent. By way of comparison, the volatility of the S&P500 index is about 15 percent, substantially lower than the 35 percent average of the firms that constitute the index due to "law of large numbers" effects.

Figure 2



The distribution of dividend yields is presented in Figure 3. There is much less variability in dividend yields than in stock price volatilities for the vast majority of firms and the distribution of yields is more positively skewed than the distribution of volatilities. The most frequent dividend yield range is 0 to 1 percent; nearly 50 percent of the sample have dividend yields in this range. The distribution is skewed toward the right with a median of 1.5 percent and an average of 3.86 percent.

Figure 3



*The Impact of Vesting and Marketability Restrictions*

Employee stock options usually must be held for 2 or 3 years from the grant date before the grant recipient actually owns the options. This period is commonly referred to as the vesting period. Restrictions on exercise during the vesting period reduce the value of an option slightly for two reasons—first, it may be desirable to exercise during the vesting period to capture dividends, and second, the options may never vest at all. Figure 4 shows the effect of varying the exercise restriction on option values for stocks with different dividend yields. The example uses the at-the-money, ten-year option, with current stock value at $100, a risk-free interest rate of 7.5 percent and a volatility of .35.

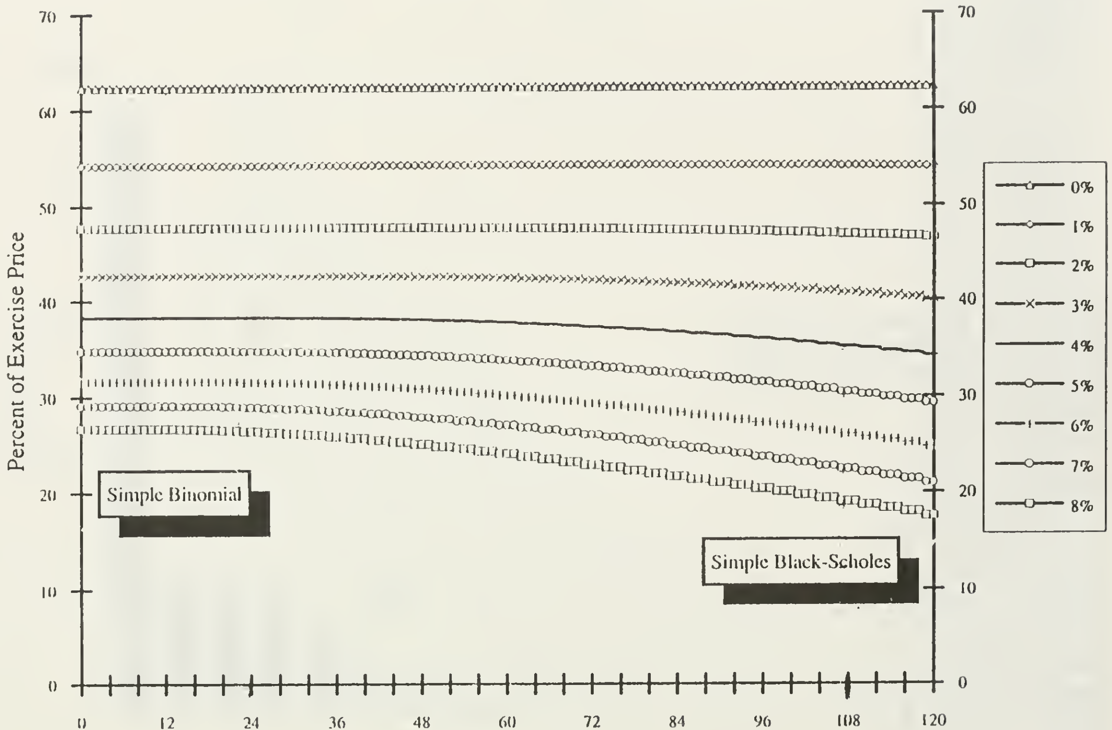



Figure 4. Exercise restrictions significantly reduce option values below simple binomial model values if the dividend yield is above 5% or the exercise restriction goes beyond the usual three years.

Significantly, for options on stocks with low dividend yields, the prohibition on early exercise does not lower the option value by much. Requiring that employees not exercise an option until the end of ten years, effectively turning an American option into a European option, only reduces the value of an option on a stock with a dividend yield of 2% by about 2.4%. Restricting exercisability for 5 years reduces the value only .2%! The value of an option on a stock paying a 4% dividend doesn't decline by 1% until the vesting period is extended beyond 4 years. Even for an option on a stock paying an 8% dividend, the value lost if the option cannot be exercised for 3 years is only 3.2%. Clearly, the lack of exercisability of employee options does not warrant a discount from the binomial model's value.

The second reason vesting restrictions might matter is that the options may not ultimately vest, sometimes called ownership or forfeiture risk. Virtually all options currently used vest immediately and must be exercised within a short period if the employee dies, leaves the firm with the consent of the board, or there is a change in control of the firm. Ordinarily, executive options only fail to vest when an executive is dismissed for cause or otherwise inimically leaves the firm. Thus, option values should be further discounted in proportion to the likelihood that regular employees will leave the firm during vesting and that executives will leave in a confrontational manner. For example, if two percent of the options are expected to fail to vest, the value for the options would be 98 percent of the value if all were to vest. The discount necessary to reflect the costs saved by shareholders when options fail to vest appears to be, in most cases, fairly small, for the simple reason that only a few options fail to vest.

*Marketability*

It is widely argued that option values should be further discounted because employees cannot sell their options, and the options are thus less valuable to the employees. This contention completely misses the goal of the valuation exercise which is to measure the cost to shareholders of the options granted. If a firm were to give an employee a company car, the compensation would be valued at its market price without considering whether this or that employee already has two cars and will bear costs of selling one of them. Extending this argument to employee stock options, the options should be valued at what they could be sold for in a competitive market. In any case, so long as the employee is going to maintain shares in the firm greater than the number of outstanding options she owns there is no cost to not exercising the options.

*Early Exercise*

Employees usually exercise options earlier than our option pricing models predict they would. In fact, they generally exercise options shortly after the options vest well before the 10 years to expiration. This early exercise is not an "optimal" exercise in the sense that the stream of future dividends is worth more than the option value (difference between the option price and the stock price less the exercise price). Employees exercise early because they cannot sell their options, they "need the cash", or they have very undiversified investments with so much of their financial wealth and human capital tied up in the fortunes of a single firm. The position here may at first seem inconsistent with the earlier point that options should not be discounted for restrictions on transferability. It is not. If the options were not transferable, but also never exercised early, no discount would be appropriate. But early exercise does truly lower the cost of options to shareholders, and the appropriate discount is one which reflects this lower cost.

The FASB Exposure Draft on expensing stock options recommends that firms whose employees exercise options early value their options as if the expiration date were the average time to exercise instead of using the contractual expiration date.[12] Alternatively, issuers who find that option grantees are consistently exercising early could simply shorten the contractual time to exercise to coincide with the time when employees generally exercise, soon after the vesting date. Note that at-the-money options that vest immediately upon the grant date are essentially identical to stock appreciation rights, which are expensed when granted and are marked-to-market throughout their lifetime.

Yet another alternative is for issuers to extend the vesting period for employee stock options. What drives the choice? Why would a company want to grant 10 year options when these options typically vest and are exercised after three years? Perhaps because the justification offered to shareholders for the use of options is, logically enough, that options help align the interests of employees and shareholders.

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[12] Financial Accounting Standards Board, *Exposure Draft: Accounting for Stock Options*, June 30, 1993.

From this perspective, the 10 years looks good, and 3 years, not so good. But if companies disclose in the estimates of value of options granted that the expected life of the options is only 2 years, how much long-term alignment is there? The holding period can of course be extended by extending the vesting period.

One more haircut for option values has been proposed: because employees, especially executives, may possess non public (inside) information, they cannot exercise their options around dates, such as earnings announcements, when information is about to become public. Therefore, it is argued this imagined implicit restriction on exercise should lower the value of the option.

This logic is flawed. First, the restrictions on insider trading do not prohibit the exercise of the options, but only the sale of the stock purchased with the exercise of the option. Second, the binomial valuation method assumes that when options are exercised early, they are exercised rationally—that is, the exercise is profit-maximizing strategy, and hence, all early exercises are done immediately prior to an ex-dividend date. Thus, the method already assumes that there is no exercise around an earnings announcement, so incorporating "no exercise" around these dates would not change the value.

## Conclusion

The methods now available for valuing options are not merely reliable, they are intuitive, compelling, cheap and easy to use. An "expert" is not needed; any investor who has rudimentary computer skills (or access to someone who does) can do all of the work necessary. For little more than the time it takes to copy the code in the appendices following this article, any issuer or investor has the tools needed to generate in-house option values. All accounting conventions are subject to an implied reasonableness test, which surely includes not only reliability, but also materiality.

At one time stock options were exotic, there were no methods for valuing options, and stock options granted to employees were so rare as to have little impact on compensation expense or net income. And so they were largely ignored by accountants and securities regulators. But options are no longer trivial. As many firms complain, and many experts' estimates of employee stock options values attest, for some firms the value of stock options granted to employees is a substantial fraction of earnings. Does this imply a material new "cost" to shareholders, as some companies complain? It does not. Shareholders bear the costs of stock options regardless of whether the cost is expensed or not; the FASB proposal simply acknowledges the presence of that cost and requires that it be reported on the income statement with the other costs.

Appendix 1a: This LOTUS 123 macro calculates the Black-Scholes and the binomial model values for an executive option based on parameters supplied by the valuator. To use, simply type in the input variables and enter Alt O. 1/

| | A | B | C | D |
|---|---|---|---|---|
| 1 | DATASET: BINOMIAL.WK1 | | | '{goto}a23~'TOTAL NUMBER OF DIVIDENDS -{right}(b11*b13){down}{left} |
| 2 | | | | "TOTAL NUMBER OF PERIODS -{right}(120){down}{left} |
| 3 | TYPE ALT O TO DETERMINE VALUE OF OPTION | | | "PERIODS PER YEAR -{right}(b24/b11){down}{left} |
| 4 | | INPUT | | "QUARTERLY DIVIDEND YIELD -{right}@if(b13>0,b12/b13,0){down}{left} |
| 5 | | VARIABLES | | "PERIODS TO FIRST EX-DIVIDEND DATE -{right}(b25/12)*b14{down}{left} |
| 6 | | | | "TIME INCREMENTS BETWEEN DIVIDENDS -{right}@if(b13>0,b25/b13,0){down}{left} |
| 7 | STOCK PRICE - | 100 | | "INTEREST RATE PER PERIOD -{right}(1+b9)^(1/b25){down}{left} |
| 8 | EXERCISE PRICE - | 100 | | "PERIODS TO VESTING -{right}(b25*b15){down}{left} |
| 9 | RISK-FREE RATE - | 7.50% | | "PROBABILITY OF VESTING -{right}(1-b16)^b15{down}{left} |
| 10 | STANDARD DEVIATION - | 0.300 | | "U -{right}@exp(b10*@sqrt(1/b25)){down}{left} |
| 11 | YEARS TO MATURITY - | 10 | | "D -{right}1/b32{down}{left} |
| 12 | ANNUAL DIVIDEND YIELD - | 5.00% | | "P -{right}(b29-b33)/(b32-b33)~ |
| 13 | NUMBER OF DIVIDENDS PER YEAR - | 4 | | '{goto}a38~'PVK -{right}(b8*((1+b9)^(-b11))){down}{left} |
| 14 | MONTHS TO FIRST EX DIVIDEND DATE - | 1.5 | | "Adjusted Price -{right}+b7*((1-(@if(b13>0,b12/b13,0)))^(b13*b11)){down}{left} |
| 15 | YEARS TO VESTING - | 0 | | "h -{right}((@LN(b39/b38))/(b10*@SQRT(b11)))+(1/2)*(b10*@SQRT(b11)){down}{left} |
| 16 | ANNUAL HAZARD RATE - | 0.0% | | "n -{right}+1-((1/((2*@PI)^(1/2)))*@EXP((b40^2)/-2))*(0.43618*(1/(1+0.33267*b40))-0.12017*(1/(1+0.33267*b40))^2+0.93730*(1/(1+0.33267*b40))^3){down}{left} |
| 17 | | | | "nsx -{right}+b40-(b10*@SQRT(b11)){down}{left} |
| 18 | VALUE OF OPTION | | | "nx -{right}+1-((1/((2*@PI)^(1/2)))*@EXP((b42^2)/-2))*(0.43618*(1/(1+0.33267*b42))-0.12017*(1/(1+0.33267*b42))^2+0.93730*(1/(1+0.33267*b42))^3){down}{left} |
| 19 | BLACK SCHOLES | | | '{goto}b19~+b31*(b39*b41-b38*b43)~ |
| 20 | BINOMIAL - | | | '/rif~~ |
| 21 | | | | '/rvb19.b34~b19.b34~ |
| 22 | | | | '{goto}b58~(b24)~{right}(b58-1)~ |
| 23 | | | | '{goto}b59~(b58>$b$27)*@if($b$28>0,@int((b58-$b$27)/$b$28)+1,1)~{right} |
| 24 | | | | '(c58>$b$27)*@if($b$28>0,@int((c58-$b$27)/$b$28)+1,1)~{right} |
| 25 | | | | '{goto}a60~(0){down} |
| 26 | | | | '({up}+1)~ |
| 27 | | | | '/c~.{down (b24-1)}~ |
| 28 | | | | '{goto}b60~ |
| 29 | | | | '@max(($b$7*((1-$b$26)^b$59)*($b$32^$a60)*($b$33^(b$58-$a60))-$b$8),0)~ |
| 30 | | | | '/c~.{down (b24)}~ |
| 31 | | | | '{goto}c60~ |
| 32 | | | | '@max((c$58>=$b$30)*($b$7*((1-$b$26)^c$59)*($b$32^$a60)*($b$33^(c$58-$a60))-$b$8),(($b$34*b61)+(1-$b$34)*b60)/$b$29)~ |
| 33 | | | | '/c~.{down (b24)}~ |
| 34 | | | | '{goto}c58~ |
| 35 | | | | '/rv{end}{down}~d58~ |
| 36 | | | | '{goto}a58~(d58-1)~ |
| 37 | | | | '{goto}c59~ |
| 38 | | | | '/c{end}{down}~a59~ |
| 39 | | | | '/rva50.c8192~a58.c8192~ |
| 40 | | | | '{goto}a50~ |
| 41 | | | | '/rv{end}{down}~d58~ |
| 42 | | | | '{if a58>0}{branch d40} |
| 43 | | | | '{goto}b20~(c60*b31)~ |
| 44 | | | | '/rif~~ |
| 45 | | | | '/rv~~ |
| 46 | | | | '/rea23.b43~ |
| 47 | | | | '/rea58.e8192~ |
| 48 | | | | '{goto}a1~{quit} |

1/ To create this spreadsheet, type in exactly as indicated. Then name the macro block (cells d1 through d48) "\O". Use the commands "/rnc" to name the macro block.

Appendix 1b: This QUATTRO PRO macro calculates the Black-Scholes and the binomial model values for an executive option based on parameters supplied by the valuator. To use, simply type in the input variables and enter Alt_O. 1/

| | A | B | C | D |
|---|---|---|---|---|
| 1 | DATASET: BINOMIAL.WQ1 | | | '{goto}a23~'TOTAL NUMBER OF DIVIDENDS - {right} (b11*b13) {down} {left} |
| 2 | | | | "TOTAL NUMBER OF PERIODS - {right} (120) {down} {left} |
| 3 | TYPE ALT_O TO DETERMINE VALUE OF OPTION | | | "PERIODS PER YEAR - {right} (b24/b11) {down} {left} |
| 4 | | INPUT | | "QUARTERLY DIVIDEND YIELD - {right} @if(b13>0,(b12/b13),0) {down} {left} |
| 5 | | VARIABLES | | "PERIODS TO FIRST EX-DIVIDEND DATE - {right} (b25/12)*b14 {down} {left} |
| 6 | | | | "TIME INCREMENTS BETWEEN DIVIDENDS - {right} @if(b13>0,(b25/b13),0) {down} {left} |
| 7 | STOCK PRICE - | 100 | | "INTEREST RATE PER PERIOD - {right} (1+b9) ^ (1/b25) {down} {left} |
| 8 | EXERCISE PRICE - | 100 | | "PERIODS TO VESTING - {right} (b25*b15) {down} {left} |
| 9 | RISK-FREE RATE - | 7.50% | | "PROBABILITY OF VESTING - {right} (1-b16) ^ b15 {down} {left} |
| 10 | STANDARD DEVIATION - | 0.300 | | "U - {right} @exp(b10*@sqrt(1/b25)) {down} {left} |
| 11 | YEARS TO MATURITY - | 10 | | "D - {right} 1/b32 {down} {left} |
| 12 | ANNUAL DIVIDEND YIELD | 5.00% | | "P - {right} (b29-b33)/(b32-b33) ~ |
| 13 | NUMBER OF DIVIDENDS PER YEAR - | 4 | | '{goto}a30~'PVK - {right} (b8*((1+b9) ^ (-b11))) {down} {left} |
| 14 | MONTHS TO FIRST EX DIVIDEND DATE - | 1.5 | | "Adjusted Price - {right} +b7*((1-(@if(b13>0,b12/b13,0))) ^ (b13*b11)) {down} {left} |
| 15 | YEARS TO VESTING - | 0 | | "h - {right} ((@LN(b39/b38))/(b10*@SQRT(b11))) + (1/2)*(b10*@SQRT(b11)) {down} {left} |
| 16 | ANNUAL HAZARD RATE - | 0.0% | | "n - {right} +1-((1/((2*@PI) ^ (1/2)))*@EXP((b40 ^ 2)/-2))*(0.43618*(1/(1+0.33267*b40)) 0.12017*(1/(1+0.33267*b40)) ^ 2+0.93730*(1/(1+0.33267*b40)) ^ 3) {down} {left} |
| 17 | | | | "hsx - {right} +b40 (b10*@SQRT(b11)) {down} {left} |
| 18 | VALUE OF OPTION | | | "nx - {right} +1-((1/((2*@PI) ^ (1/2)))*@EXP((b42 ^ 2)/-2))*(0.43618*(1/(1+0.33267*b42)) 0.12017*(1/(1+0.33267*b42)) ^ 2+0.93730*(1/(1+0.33267*b42)) ^ 3) {down} {left} |
| 19 | BLACK SCHOLES | | | '{goto}b19~+b31*(b39*b41 b38*b43)~ |
| 20 | BINOMIAL - | | | '{/ Block,Format}f~b19~ |
| 21 | | | | '{/ Block,Values}b19.b44~b19.b44~ |
| 22 | | | | '{goto}b58~(b24)~{right}(b58-1)~ |
| 23 | | | | '{goto}b59~(b58>$b$27)*@if($b$28>0,(@int((b58-$b$27)/$b$28)+1),1)~{right} |
| 24 | | | | '(c58>$b$27)*@if($b$28>0,(@int((c58-$b$27)/$b$28)+1),1)~{right} |
| 25 | | | | '{goto}a60~(0){down} |
| 26 | | | | '({up}+1)~ |
| 27 | | | | '{/ Block,Copy}~.{down (b24-1)}~ |
| 28 | | | | '{goto}b60~ |
| 29 | | | | '@max(($b$7*((1-$b$26) ^ b$59)*($b$32 ^ $a60)*($b$33 ^ (b$58 $a60))-$b$8),0)~ |
| 30 | | | | '{/ Block,Copy}~.{down (b24)}~ |
| 31 | | | | '{goto}c60~ |
| 32 | | | | '@max((c$58>=$b$30)*($b$7*((1-$b$26) ^ c$59)*($b$32 ^ $a60)*($b$33 ^ (c$58 $a60))-$b$8),(($b$34*b61)+(1-$b$34)*b60)/$b$29)~ |
| 33 | | | | '{/ Block,Copy}~.{down (b24)}~ |
| 34 | | | | '{goto}c58~ |
| 35 | | | | '{/ Block,Values}{end}{down}~d58~ |
| 36 | | | | '{goto}c58~(d58-1)~ |
| 37 | | | | '{goto}c59~ |
| 38 | | | | '{/ Block;Copy}{end}{down}~a59~ |
| 39 | | | | '{/ Block,Values}a58.c8192~a58.d8192~ |
| 40 | | | | '{goto}a58~ |
| 41 | | | | '{/ Block,Values}{end}{down}~d58~ |
| 42 | | | | '{if a58>0}{branch d40} |
| 43 | | | | '{goto}b20~(a60*b31)~ |
| 44 | | | | '{/ Block,Format}f~b20~ |
| 45 | | | | '{/ Block,Values}~~ |
| 46 | | | | '{/ Block,Erase}a23.b43~ |
| 47 | | | | '{/ Block,Erase}a58.a8192~ |
| 48 | | | | '{goto}a1~{quit} |

1/ To create this spreadsheet, type in exactly as indicated. Then name the macro block (cells d1 through d48) "\O". Use the commands "/nnc" to name the macro block.

**Appendix 1c: This EXCEL macro calculates the Black-Scholes and the binomial model values for an executive option based on parameters supplied by the valuator. To use, simply type in the input variables and enter Cntl_O. 1/**

| | WORKSHEET A | B |
|---|---|---|
| 1 | DATASET BINOMIAL.XLS | |
| 2 | | |
| 3 | TYPE CNTL_O TO DETERMINE VALUE OF OPTION | |
| 4 | | |
| 5 | | INPUT |
| 6 | | VARIABLES |
| 7 | STOCK PRICE : | 100 |
| 8 | EXERCISE PRICE : | 100 |
| 9 | RISK-FREE RATE : | 7.50% |
| 10 | STANDARD DEVIATION | 0.300 |
| 11 | YEARS TO MATURITY | 10 |
| 12 | ANNUAL DIVIDEND YIELD : | 5.00% |
| 13 | NUMBER OF DIVIDENDS PER YEAR : | 4 |
| 14 | MONTHS TO FIRST EX DIVIDEND DATE : | 1.5 |
| 15 | YEARS TO VESTING | 0 |
| 16 | ANNUAL HAZARD RATE : | 0.0% |
| 17 | | |
| 18 | VALUE OF OPTION | |
| 19 | BLACK SCHOLES : | |
| 20 | BINOMIAL : | |
| 21 | | |
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| 41 | | |
| 42 | | |

| | MACRO SHEET A |
|---|---|
| 1 | =FORMULA("TOTAL NUMBER OF DIVIDENDS :",!$A$23) =FORMULA("=R11C2*R13C2",!$B$23) |
| 2 | =FORMULA("TOTAL NUMBER OF PERIODS :",!$A$24) =FORMULA("=120",!$B$24) |
| 3 | =FORMULA("PERIODS PER YEAR :",!$A$25) =FORMULA("=R24C2/R11C2",!$B$25) |
| 4 | =FORMULA("QUARTERLY DIVIDEND YIELD :",!$A$26) =FORMULA("=IF(R13C2>0,R12C2/R13C2,0)",!$B$26) |
| 5 | =FORMULA("PERIODS TO FIRST EX DIVIDEND DATE :",!$A$27) =FORMULA("=R25C2*R14C2/12",!$B$27) |
| 6 | =FORMULA("TIME INCREMENTS BETWEEN DIVIDENDS :",!$A$28) =FORMULA("=IF(R13C2>0,R25C2/R13C2,0)",!$B$28) |
| 7 | =FORMULA("INTEREST RATE PER PERIOD :",!$A$29) =FORMULA("=(1+R9C2)^(1/R25C2)",!$B$29) |
| 8 | =FORMULA("PERIODS TO VESTING :",!$A$30) =FORMULA("=R25C2*R15C2",!$B$30) |
| 9 | =FORMULA("PROBABILITY OF VESTING :",!$A$31) =FORMULA("=(1-R16C2)^R15C2",!$B$31) |
| 10 | =FORMULA("U :",!$A$32) =FORMULA("=EXP(R10C2*SQRT(1/R25C2))",!$B$32) |
| 11 | =FORMULA("D :",!$A$33) =FORMULA("=1/R32C2",!$B$33) |
| 12 | =FORMULA("P :",!$A$34) =FORMULA("=(R29C2-R33C2)/(R32C2-R33C2)",!$B$34) |
| 13 | =FORMULA("PVK :",!$A$38) =FORMULA("=R8C2*(1+R9C2)^(-R11C2)",!$B$38) |
| 14 | =FORMULA("ADJUSTED PRICE :",!$A$39) =FORMULA("=R7C2*((1-(IF(R13C2>0,R12C2/R13C2,0)))^(R13C2*R11C2))",!$B$39) |
| 15 | =FORMULA("H :",!$A$40) =FORMULA("=((LN(R39C2/R38C2))/(R10C2*SQRT(R11C2)))+(1/2)*(R10C2*SQRT(R11C2))",!$B$40) |
| 16 | =FORMULA("N :",!$A$41) =FORMULA("=NORMSDIST(R40C2)",!$B$41) |
| 17 | =FORMULA("NX :",!$A$42) =FORMULA("=NORMSDIST(R40C2-R10C2*SQRT(R11C2))",!$B$42) |
| 18 | =FORMULA("=R31C2*(R39C2*R41C2-R38C2*R42C2)",!$B$19) |
| 19 | =SELECT("R19C2") =FORMAT.NUMBER("0.00") |
| 20 | =COPY() =PASTE.SPECIAL(3,1,FALSE,FALSE) =CANCEL.COPY() |
| 21 | =SELECT("R18C2:R42C2") =COPY() =PASTE.SPECIAL(3,1,FALSE,FALSE) =CANCEL.COPY() |
| 22 | =FORMULA("=R24C2",!$B$58) =FORMULA("=R58C2-1",!$C$58) |
| 23 | =FORMULA("=IF(R[-1]C[0]>R27C2,IF(R28C2>0,INT((R[-1]C[0]-R27C2)/R28C2)+1,1),0)",!$B$59) |
| 24 | =FORMULA("=IF(R[-1]C[0]>R27C2,IF(R28C2>0,INT((R[-1]C[0]-R27C2)/R28C2)+1,1),0)",!$C$59) |
| 25 | =FORMULA("=0",!$A$60) =FORMULA("=R[-1]C[0]+1",!$A$61) |
| 26 | =COPY(!$A$61,!$A$61:$A$180) |
| 27 | =FORMULA("=MAX((R7C2*((1-R28C2)^R58C[0]))*(R32C2^R[0]C1)*(R33C2^(R58C[0]-R[0]C1))-R8C2),0)",!$B$60) |
| 28 | =COPY(!$B$60,!$B$60:$B$180) |
| 29 | =FORMULA("=MAX(IF((R58C[0]>=R30C2),(R7C2*((1-R28C2)^R58C[0]))*(R32C2^R[0]C1)*(R33C2^(R58C[0]-R[0]C1))-R8C2),0),((R34C2*R[1]C[-1])+(1-R34C2)*R[0]C[-1])/R29C2)",!$C$60) |
| 30 | =COPY(!$C$60,!$C$60:$C$180) |
| 31 | =SELECT("R58C3:R180C3") =COPY() =SELECT("R58C4") =PASTE.SPECIAL(3,1,FALSE,FALSE) =CANCEL.COPY() |
| 32 | =FORMULA("=R[0]C[-1]-1",!$E$58) |
| 33 | =SELECT("R58C3:R180C3") =COPY() =SELECT("R58C5") =PASTE() =CANCEL.COPY() |
| 34 | =SELECT("R58C1:R180C3") =COPY() =PASTE.SPECIAL(1,1,FALSE,FALSE) =CANCEL.COPY() |
| 35 | =SELECT("R58C5:R180C5") =COPY() =SELECT("R58C4") =PASTE.SPECIAL(3,1,FALSE,FALSE) =CANCEL.COPY() |
| 36 | =IF(!$E$58>0,GOTO($A$15),GOTO($A$37)) |
| 37 | =FORMULA("=R60C5*R31C2",!$B$20) |
| 38 | =SELECT("R20C2") =FORMAT.NUMBER("0.00") |
| 39 | =COPY() =PASTE.SPECIAL(3,1,FALSE,FALSE) =CANCEL.COPY() |
| 40 | =SELECT("R23C1:R180C5") =CLEAR(1) |
| 41 | =SELECT("R1C1") |
| 42 | =HALT() |

1/ To create these sheets, type the worksheet exactly as indicated. Open a macro sheet using FILE then NEW then MACRO SHEET and type the macro sheet exactly as indicated.

Appendix 2. The volatility estimates below are calculated using weekly closing prices for General Motor's common stock and the S&P500 index. General Motor's prices are adjusted for cash dividends and stock splits on the first date after an ex-dividend date. The standard deviation of the natural logarithms of ratios of adjusted prices divided by the previous week's unadhusted closing price is multiplied by the square root of 52 to determine an anuual volatility of .366 or 36.6% for General Motors and .0867 or 8.67% for the S&P500 index. Using daily data results in only slightly different results. For details and an explanation of this method for calculating volatilites see Cox and Rubenstein, Chapter 6.

| Date | GM Price | Dividend | Adjusted Price | Natural log of ratios | S & P 500 Index | Natural log of ratios |
|---|---|---|---|---|---|---|
| 92/01/03 | $32.500 | $0.00 | $32.500 | | 419.34 | |
| 92/01/10 | $31.750 | $0.00 | $31.750 | -0.0233470 | 415.10 | -0.0101630 |
| 92/01/17 | $33.875 | $0.00 | $33.875 | 0.0647846 | 418.86 | 0.0090173 |
| 92/01/24 | $32.750 | $0.00 | $32.750 | -0.0337740 | 415.48 | -0.0081020 |
| 92/01/31 | $32.375 | $0.00 | $32.375 | -0.0115160 | 408.79 | -0.0162330 |
| 92/02/07 | $34.000 | $0.40 | $34.400 | 0.0606700 | 411.09 | 0.0056106 |
| 92/02/14 | $38.125 | $0.00 | $38.125 | 0.1145097 | 412.48 | 0.0033756 |
| 92/02/21 | $38.375 | $0.00 | $38.375 | 0.0065360 | 411.46 | -0.0024760 |
| 92/02/28 | $37.500 | $0.00 | $37.500 | -0.0230650 | 412.70 | 0.0030091 |
| 92/03/06 | $36.875 | $0.00 | $36.875 | -0.0168070 | 404.44 | -0.0202180 |
| 92/03/13 | $37.125 | $0.00 | $37.125 | 0.0067568 | 405.84 | 0.0034556 |
| 92/03/20 | $39.125 | $0.00 | $39.125 | 0.0524711 | 411.30 | 0.0133639 |
| 92/03/27 | $36.750 | $0.00 | $36.750 | -0.0626230 | 403.50 | -0.0191460 |
| 92/04/03 | $36.250 | $0.00 | $36.250 | -0.0136990 | 401.55 | -0.0048440 |
| 92/04/10 | $38.625 | $0.00 | $38.625 | 0.0634604 | 404.29 | 0.0068004 |
| 92/04/16 | $42.250 | $0.00 | $42.250 | 0.0897046 | 416.05 | 0.0286730 |
| 92/04/24 | $39.625 | $0.00 | $39.625 | -0.0641440 | 409.02 | -0.0170410 |
| 92/05/01 | $40.875 | $0.00 | $40.875 | 0.0310584 | 412.53 | 0.0085449 |
| 92/05/08 | $39.875 | $0.00 | $39.875 | -0.0247690 | 416.05 | 0.0084965 |
| 92/05/15 | $39.250 | $0.00 | $39.250 | -0.0157980 | 410.09 | -0.0144290 |
| 92/05/22 | $39.125 | $0.00 | $39.125 | -0.0031900 | 414.02 | 0.0095376 |
| 92/05/29 | $39.875 | $0.00 | $39.875 | 0.0189879 | 415.35 | 0.0032073 |
| 92/06/05 | $44.000 | $0.40 | $44.400 | 0.1074899 | 413.48 | -0.0045120 |
| 92/06/12 | $43.125 | $0.00 | $43.125 | -0.0200870 | 409.76 | -0.0090380 |
| 92/06/19 | $43.875 | $0.00 | $43.875 | 0.0172418 | 403.67 | -0.0149740 |
| 92/06/26 | $42.625 | $0.00 | $42.625 | -0.0289040 | 403.46 | -0.0005200 |
| 92/07/02 | $41.125 | $0.00 | $41.125 | -0.0358250 | 411.77 | 0.0203876 |
| 92/07/10 | $41.000 | $0.00 | $41.000 | -0.0030440 | 414.62 | 0.0068975 |

| Date | GM Price | Dividend | Adjusted Price | Natural log of ratios | S & P 500 Index | Natural log of ratios |
|---|---|---|---|---|---|---|
| 92/07/17 | $40.750 | $0.00 | $40.750 | -0.00612 | 415.62 | 0.00241 |
| 92/07/24 | $39.250 | $0.00 | $39.250 | -0.03750 | 411.6 | -0.00972 |
| 92/07/31 | $41.625 | $0.00 | $41.625 | 0.05875 | 424.21 | 0.03018 |
| 92/08/07 | $37.000 | $0.00 | $37.000 | -0.01178 | 418.88 | -0.01264 |
| 92/08/14 | $36.875 | $0.40 | $37.275 | 0.00740 | 419.91 | 0.00246 |
| 92/08/21 | $35.375 | $0.00 | $35.375 | -0.04153 | 414.85 | -0.01212 |
| 92/08/28 | $33.500 | $0.00 | $33.500 | -0.05446 | 414.84 | -0.00002 |
| 92/09/04 | $35.125 | $0.00 | $35.125 | 0.04737 | 417.08 | 0.00539 |
| 92/09/11 | $33.625 | $0.00 | $33.625 | -0.04364 | 419.58 | 0.00598 |
| 92/09/18 | $34.125 | $0.00 | $34.125 | 0.01476 | 422.93 | 0.00795 |
| 92/09/25 | $32.000 | $0.00 | $32.000 | -0.06429 | 414.35 | -0.02050 |
| 92/10/02 | $30.875 | $0.00 | $30.875 | -0.03579 | 410.47 | -0.00941 |
| 92/10/09 | $29.125 | $0.00 | $29.125 | -0.05835 | 402.66 | -0.01921 |
| 92/10/16 | $29.375 | $0.00 | $29.375 | 0.00855 | 411.73 | 0.02228 |
| 92/10/23 | $33.500 | $0.00 | $33.500 | 0.13140 | 414.10 | 0.00574 |
| 92/10/30 | $30.750 | $0.00 | $30.750 | -0.08566 | 418.68 | 0.01100 |
| 92/11/06 | $30.625 | $0.20 | $30.825 | 0.00244 | 417.58 | -0.00263 |
| 92/11/13 | $31.125 | $0.00 | $31.125 | 0.01619 | 422.43 | 0.01155 |
| 92/11/20 | $31.000 | $0.00 | $31.000 | -0.00402 | 426.65 | 0.00994 |
| 92/11/27 | $31.625 | $0.00 | $31.625 | 0.01996 | 430.16 | 0.00819 |
| 92/12/04 | $34.000 | $0.00 | $34.000 | 0.07241 | 432.06 | 0.00441 |
| 92/12/11 | $33.500 | $0.00 | $33.500 | -0.01482 | 433.73 | 0.00386 |
| 92/12/18 | $33.125 | $0.00 | $33.125 | -0.01126 | 441.28 | 0.01726 |
| 92/12/24 | $33.000 | $0.00 | $33.000 | -0.00378 | 439.77 | -0.00343 |
| 92/12/31 | $32.250 | $0.00 | $32.250 | -0.02299 | 435.71 | -0.00927 |

| | GM | S & P 500 |
|---|---|---|
| Return's variance | 0.00258 | 0.00014 |
| Square root of return's variance | 0.05078 | 0.01202 |
| Aquare root of annual periodicity | 7.21110 | 7.21110 |
| Annualized volatility | **0.36619** | **0.08667** |
| Volatility estimate using daily data | 0.34164 | 0.09717 |

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Philip B. Chenok, CPA
President

November 1, 1993

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities of the Senate Committee
on Banking, Housing, and Urban Affairs
United States Senate
444 Russell Senate Office Building
Washington, DC 20510

Dear Chairman Dodd:

I write on behalf of the American Institute of Certified Public Accountants (AICPA) in connection with the oversight hearing you chaired on October 21, 1993, on employee stock options. My purpose in writing is not to express an opinion on the accounting that should be followed -- the AICPA has not yet developed its position on that complex issue. Rather, it is to express our view on the process that should be adhered to in setting accounting standards.

The AICPA is the national professional association of over 310,000 certified public accountants in public practice, industry, government and education. Through the efforts of volunteer members, the AICPA sets standards for audits and other services provided by CPAs in public practice, provides educational guidance materials to its members, administers the Uniform CPA Examination, and monitors and enforces through practice reviews and other means compliance with the profession's technical and ethical standards. All of these activities are undertaken with the objective of assisting our members in their efforts to serve the public interest.

As you know, pending legislation in both the Senate and the House (S. 259, S. 1175, H.R. 2759, and H.R. 2878) would statutorily mandate financial accounting standards for stock options granted to employees. The AICPA is strongly opposed to any legislation that would seriously harm the ability of the independent Financial Accounting Standards Board to continue in its role as the private sector body that sets accounting standards for American businesses, standards that are universally recognized as the most comprehensive in the world. We fear that the pending legislation, if enacted, would cause such harm.

The Honorable Christopher J. Dodd
November 1, 1993
Page 2.

Until 1973, the AICPA, through its Accounting Principles Board, established the generally accepted accounting principles that are followed by businesses and other entities in preparing financial statements for investors, creditors, and the general public. In that year, the AICPA ceded that authority to the Financial Accounting Standards Board (FASB). The FASB is sponsored and funded by American businesses, by the AICPA, and by accounting firms. Its activities are closely monitored by the Securities and Exchange Commission, which has since its inception looked to the private sector -- and in particular the accounting profession -- to establish and improve accounting standards in the public interest. The FASB has been effective in achieving that objective.

The Chief Accountant of the Securities and Exchange Commission and the Chairman of the FASB have sent you letters and submissions that describe in detail how the FASB goes about the process of setting standards. I will restrict myself to providing other background information.

The FASB was established in 1973 as the result of recommendations contained in Establishing Financial Accounting Standards: Report of the Study on Establishment of Accounting Principles, frequently referred to as the report of the Wheat Committee, after its chairman, former SEC Commissioner Francis M. Wheat. Among many other subjects, the committee considered "the threshold question" of whether standards should be set in the private sector or the public sector. The committee, which included only a minority of practicing CPAs, concluded unequivocally that accounting standard setting should take place in the private sector. Here is an excerpt from the committee's report which we believe is right on point:

> ...there are distinct disadvantages to transferring the standard-setting function to the public sector. One very real concern is that government agencies may be more susceptible to political pressures than private bodies. This could lead to accounting standards being designed to accomplish the self-serving objectives of private interest groups rather than solely to meet the needs of those who use financial statements in making economic decisions. The political pressures evident in 1971 when Congressional action was taken to regulate the accounting treatment of the investment tax credit reinforce this concern. [emphasis added.]

A few years later, the new FASB was already under attack. In a submission in 1977 to the Subcommittee on Reports, Accounting and Management of the U.S. Senate Committee on Governmental Affairs, the AICPA said this:

> When the alleged shortcomings of the FASB are fully cataloged, there is no evidence that the job of determining financial accounting standards could better be done by a government body. Would the job be done more quickly? If so, it would be at the expense of the careful research, analysis, and opportunity for public hearings that have preceded FASB pronouncements. Would the determinations of a governmental standard-setting group be solely concerned with full and fair disclosure and protection of investors? Or would such determinations become infected with other considerations? Would a governmental body have decided to require a different approach to accounting for research and development to assist small business without concern for the effect of such a determination on investors in public companies?

True, the pending legislation does not propose the wholesale relocation of standard-setting authority to government. But the fact is that a single significant legislative interference in the objective process followed by the FASB is a major step down a slippery slope to that very result. Again, to quote from the report of the Wheat Committee:

> It may at some time become clear beyond question that standard-setting cannot be left in private hands. But that time is not yet. Until it is shown without doubt that this task must be entrusted to government, we strongly prefer to keep it where it is. There are two prerequisites for the success of such an undertaking in the private sector. These are the existence of a tradition of standard-setting and the participation, at the core of the process, of a well-organized profession anxious to make the process work. In the field of accounting, these two prerequisites are satisfied.

Mr. Chairman, those prerequisites were satisfied in 1973 and they continue to be satisfied now.

The first chairman of the FASB, Marshall Armstrong, often made statements along the following lines: "Everyone supports standard-setting in the private sector until it is perceived that their ox is being gored." Those who argue for legislative intervention in the accounting for employee stock options -- who are largely financial statement preparers, not users of those statements -- perceive that their ox is being gored. They naturally seek a remedy, but a legislative remedy is the wrong one. It is a remedy that will achieve a narrow purpose but that in the end will be destructive to a process that operates in the public interest.

The procedures of the FASB provide for the collection and analysis of information and views from all sources. The FASB has at this time only issued an exposure draft. Many other due process procedures remain to be carried out. For example, the FASB plans to hold two public hearings following the close of the comment period and will engage in extensive field testing of its proposals. Those interested in the final decision should avail themselves of those procedures. And all of us interested in the standard-setting process should consider these comments by SEC Chairman Arthur Levitt in connection with his recent confirmation hearings:

> I believe firmly that the FASB process should run its course. The American accounting standards setting process has worked well. FASB is a highly respected, expert and independent body that has acted as the primary accounting standard setter since 1973. The Commission, pursuant to the federal securities laws, has full authority to set accounting standards for publicly held companies. I can assure you that the Commission will actively oversee the FASB's process and all FASB's actions with respect to stock option accounting, with a view to assuring that any resulting accounting standard is consistent with the protection of investors and the public interest. The Commission, like the FASB, will carefully consider the comments received on the FASB's exposure draft and take those into account in exercising its oversight authority.
>
> Various bills have been introduced in Congress both favoring and opposing the expensing of options. Legislation on this issue, in my view, would not be wise. Accounting standards are best set by the process we have today.

The Honorable Christopher J. Dodd
November 1, 1993
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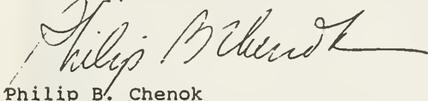
The views that are ultimately expressed by the AICPA on the specific accounting standards for employee stock options may or may not be reflected in a final FASB statement. But the AICPA will remain convinced that such a statement will have been adopted only after the most careful and objective consideration and that it, like every other FASB statement, should be followed by American business.

We respectfully request that this letter be included in the official hearing record relating to the October 21, 1993, hearing before the Securities Subcommittee on employee stock options.

Sincerely,



Philip B. Chenok

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF ACCOUNTANT

October 22, 1993

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities of the Senate Committee
on Banking, Housing, and Urban Affairs
United States Senate
444 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

I write this letter in connection with an oversight hearing you conducted concerning the issue of accounting for stock options granted to employees. I commend you for holding this hearing on an issue that may have far-reaching implications, particularly for small, high tech companies, and for investors in general. Rather than commenting on the subject of the hearing itself, I would like to share with you my perception on the appropriate role of the Securities and Exchange Commission and Congress in this process and the SEC's relationship with the Financial Accounting Standards Board as an independent standard-setting body.

The federal securities laws are intended to protect investors through the disclosure of reliable, material information. Financial statements prepared by management, and audited by independent accountants, are a central feature in this disclosure system. Since 1938, the Commission, without abdicating its responsibilities in this area, has looked to the accounting profession for leadership in establishing and improving accounting standards. Working in partnership, the SEC and the profession have established what are widely recognized as the most comprehensive accounting standards in the world, providing transparency of the economic conditions, events, and transactions affecting public entities and allowing investors to decide how the underlying facts should affect security prices and the allocation of capital. I believe that it is, in large part, the commitment in this country to an accounting system that has the objective of providing complete, transparent, and unbiased financial information to investors that has made the United States' securities markets attractive for both domestic and global capital formation.

As you know, since 1973, the FASB has been the private-sector body designated by the accounting profession to set accounting standards. The FASB's Concepts Statements, which set forth the fundamental precepts the FASB uses in setting standards, stress that financial reporting should not be viewed as an end in itself but as a means to provide information that is useful in making economic and business decisions. In order to achieve this

objective, the FASB listens to the concerns of all of its constituencies and then writes and issues, without bias or favoritism, standards that are designed to reflect economic conditions, events, and transactions as objectively as possible. The FASB's Mission Statement accents this approach by stating that the FASB must, among other things: (1) be objective in its decision making, (2) weigh carefully the views of its constituents, (3) promulgate standards only when the expected benefits exceed the perceived costs, and (4) bring about needed changes in ways that minimize disruption to the continuity of reporting practice.

To implement the Concepts Statements and Mission Statement, the meetings of the FASB concerning proposed standards are open to the public, and prior to acting on any significant proposed standard, a discussion memorandum exploring all the issues is published for public comment, public hearings are held, a draft of the proposal is published for public comment, the proposal may be "field tested," and the FASB then redeliberates the proposal. The Commission staff, through the Office of the Chief Accountant, carefully reviews each standard-setting proceeding by reading comment letters, observing FASB meetings and public hearings, and expressing its concerns and interests to the FASB and its staff. Once a standard is adopted, the SEC staff continues to consult with the FASB staff on implementation issues and whether interpretations or changes in the standard may be necessary to achieve the objective of the standard. I strongly endorse this process for setting accounting standards and believe that it should continue, unabated, in the future.

While I appreciate the concerns of Congress regarding accounting for stock options, I believe that the FASB, as an independent standard-setting body with its technical expertise, is uniquely positioned to fulfill the task of setting accounting standards and that the FASB ought to be allowed to continue its examination of this issue.

The standard-setting process in the United States, although the best in the world, is not perfect. There is room for constructive input from Congress, the business community, investor groups, and others on how the process may be improved and strengthened. Indeed, the testimony you received during this oversight hearing will provide additional valuable input to the FASB's deliberative process. In designing specific standards, however, I believe it is best to use the technical expertise available in the process that currently is in place and has worked for decades, rather than intervening in that process through Congressional action.

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I appreciate the opportunity to submit this letter, and I respectfully request that it be included in the hearing record for October twenty first. I look forward to working closely with you and your colleagues as the FASB continues to deliberate this issue.

Yours truly,

Walter Schuetze

Walter P. Schuetze
Chief Accountant

ELECTRONIC INDUSTRIES ASSOCIATION

November 1, 1993

Ms. Martha L. Cochran
Staff Director/Counsel
Committee on Banking, Housing
and Urban Affairs
Subcommittee on Securities
United States Senate
SD-534 Dirksen Senate Office Building
Washington, DC 20510-6075

Dear Ms. Cochran:

The Electronic Industries Association is pleased to submit comments to be entered into the record for the hearings your committee recently held on Thursday, October 21, 1993 with regard to the Financial Accounting Standards Board's (FASB) proposal to require companies charge earnings when they issue stock options for compensation.

EIA is a 68-year old trade organization representing the entire spectrum of companies involved in the manufacture of electronic components, parts, systems and equipment for communications, industrial, government and consumer-end uses. Our membership produced some 85% of the $285 billion in U.S. electronics production in 1992 and the industry overall employs some 2 million Americans.

For many reasons, requiring an earnings charge for stock options would significantly impact the competitiveness and productivity of the electronics industry. The high technology industry's ability to create jobs would be damaged by removing their ability to link employee pay to performance. The rule would make broad-based employee equity programs prohibitively expensive and force may companies to cut or drop their plans. Efforts to create jobs will be especially hampered in smaller firms who are forced to use methods of compensation such as stock options which do not require cash distributions but which have proven effective in attracting a quality workforce. Contrary to the belief that the use of stock options as compensation is limited to senior executives, the proposed rule could ultimately hurt the rank and file in many companies.

Recognizing this expense would raise the cost of capital formation at a time when many companies already have extremely limited resources. The reduction in earnings would lead to lower stock prices and thus a loss of investors and capital. FASB's rule would force companies to make guesswork out of estimating the value of their options at grant and reduce their reportable earnings by that amount. Moreover, requiring companies

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to speculate would create an administrative burden on employers at a time when government is endorsing a reduction in bureaucracy.

It is our belief that use of stock options in companies large and small stimulates competitiveness and profitability by expanding the number of employees in all industries who benefit from equity compensation. Pay incentives which do not require cash expenditures are especially beneficial to the start-up and small businesses which are responsible for most of the job creation in the United States. High technology industries are world leaders in promoting employee stock ownership opportunities and, as a consequence, benefit greatly from the morale and economic growth they create. Stock options enhance employee commitment and performance, conserve valuable capital and encourage investment.

EIA continues to oppose the enactment of the proposed FASB rule and supports efforts in the business community to broaden the use of equity compensation throughout America's workforce. Last month, our Board of Governors voted in an overwhelming majority to endorse the Equity Expansion Act of 1993. We support the efforts of Senators Lieberman, Mack, Boxer and Feinstein to enhance the use of employee stock purchasing plans.

Thank you for the opportunity to submit our views for the Subcommittee's consideration. Should your staff have any further questions, please invite them to contact Kim King of the EIA Government Relations Department at 202/457-8787.

Sincerely,

KEVIN C. RICHARDSON
Vice President
Government Relations

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